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IN THE

SUPREME COURT OF THE UNITED STA

OCTOBER TERM, A. D. 1934.

No. 212.

WEST OHIO GAS COMPANY, an Ohio Corpora

App

v.

THE PUBLIC UTILITIES COMMISSION OF O

App

APPEAL FROM THE SUPREME COURT OF OHIO.

BRIEF AND ARGUMENT FOR APPE

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, A. D. 1934.

No. 212.

WEST OHIO GAS COMPANY, an Ohio Corporation,
Appellant,

v.

THE PUBLIC UTILITIES COMMISSION OF OHIO,
Defendant in Error,
Appellee.

APPEAL FROM THE SUPREME COURT OF OHIO.

BRIEF AND ARGUMENT FOR APPELLANT.

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*May It Please the Court:**

OPINIONS BELOW.

This case comes up on an appeal from a judgment** of the Supreme Court of Ohio affirming a final order of

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*NOTE: Wherever throughout this Brief and Argument italicized words appear within quotations, the italics are ours unless otherwise noted.

**NOTE: So termed by the state court in its mandate issued in the cause.

appellee fixing rates to be charged by appellant for gas utility service rendered within the city of Lima, Ohio during the five-year period commencing about April 19, 1928.

The opinion of the court below appears on pages 14-35 of the printed record in this court. It is reported in 128 Ohio State 301 (1934).

The final order of appellee appears on pages 85-8 of the printed record. The original opinion of appellee accompanying said final order appears on pages 88-99 of the printed record. The original opinion was changed by a *nunc pro tunc* order of appellee, which was entered under date of May 19, 1933 without notice to appellant, and was filed in the state supreme court on May 27, 1933 without notice to appellant. This order, in which the revised pages of the original opinion are set out in full, appears on pages 118-24 of the record in this case.

JURISDICTION.

A statement as to jurisdiction has been filed by appellant and separately printed, pursuant to Rule 12 of this court. The fact that section 237 of the Judicial Code confers jurisdiction upon this court is not controverted. Probable jurisdiction was noted by this court on October 8, 1934.

STATEMENT OF THE CASE.

The rate order of appellee, which is challenged by these proceedings, was entered March 10, 1933 and fixed rates to be charged by appellant for gas utility service rendered by it to consumers within the city of Lima, Ohio for a five-year period commencing on or about April 19, 1928. This rate order drastically reduces the rates for gas utility service that have been charged in Lima.

While we shall endeavor to eliminate all non-essentials from our statement of the facts, we shall try to give the court a complete picture of all facts that might be deemed relevant to the issues to be decided. In a case of this kind, it is, we believe, essential that the court should have this at the outset of its consideration of the problems involved.

Throughout this statement, brief and argument appellant, West Ohio Gas Company, will generally be referred to as the "company;" appellee, The Public Utilities Commission of Ohio, will generally be referred to as the "commission;" and the city of Lima, Ohio, a municipal corporation, will generally be referred to either as the "city" or "Lima."

History of Proceedings.

On March 19, 1928 the city, acting under the provisions of sections 614-44, and 3982 and 3983 of the General Code of Ohio, passed an ordinance No. 2675 purporting to fix and regulate the maximum price which the company should be permitted to charge for gas utility service furnished to consumers within the city during a period of five years from and after the effective date of the ordinance. These rates were as follows: (R. 70).

First 1,000 cubic feet of gas used per month, $.90.

Next 3,000 cubic feet used per month, $.80 per thousand cubic feet.

Next 6,000 cubic feet used per month, $.75 per thousand cubic feet.

All over 10,000 cubic feet used per month, $.55 per thousand cubic feet.

The ordinance provided that it should become effective at the earliest date allowed by law. Within the time allowed by the Ohio statutes, the company filed with the commission, as cause No. 5137, its appeal from said ordi-

nance, and elected, pending the determination of this appeal, to charge the schedules of rates in force and effect on the date of the passage of the ordinance, all as authorized and provided for by sections 614-44, 614-45 and 614-46 of the General Code of Ohio.

The general rates which the company was then charging, and has since continued to charge are the following: (R. 417).

First 400 cubic feet of gas or less used per month, $1.25.

Next 9600 cubic feet used per month, $1.05 per thousand cubic feet.

Next 15,000 cubic feet used per month, $1.00 per thousand cubic feet.

All over 25,000 cubic feet used per month, $.75 per thousand cubic feet.

These rates, except as they have been modified by a voluntary reduction made by the company January 1, 1926, are the rates which were authorized under an order entered on April 25, 1925 by the commission in advance utility cause No. 179, after it had completed a valuation of the company's property devoted to the public service and a study of the estimated revenues to be derived therefrom and expenses to be incurred therein. (R. 516-21).

After the filing of said appeal the commission proceeded to hold hearings as to the valuation of the property of the company used and useful in rendering gas utility service within Lima. The initial hearing was commenced on July 12, 1928, and the company then presented its evidence as to the value of its property. Subsequent hearings were held from time to time, both the city and the commission finally presenting valuations. On January 27, 1932 the commission entered a final valuation order in said cause finding that the value as of March 31, 1928 of the

property of the company so used and useful was $1,901,696.26. This sum was the exact amount reported by the engineering staff of the commission as the value of the physical property used and useful in rendering the service. (R. 627-35, 297-303, 310-5). It included no amount whatsoever for going value. (R. 303). Deductions were made for alleged over-capacity of the plant. (R. 301). The company filed a petition for rehearing as to this final valuation, but that petition was denied. No appeal was taken from the valuation order. The company, upon electing to seek a review of the final rate order of the commission in the state court, was precluded under the Ohio statutes from attacking in that proceedings the unreasonableness of the final valuation order; and was bound before that court by the rate base that had been fixed. (See opinion of state court. 128 Oh. St. 301, 311; R. 23). See also General Code of Ohio, section 547 (Appendix C, pp. 203-4, *infra*).

Several months after the entry of the final valuation order, the commission proceeded to hold hearings relative to the revenues derived from, the cost of, and the net return earned in, rendering gas utility service to consumers in Lima. Initial hearings on this phase of the proceedings were held on June 7 and 8, 1932. At that time the company introduced its testimony and exhibits as to those matters. At subsequent hearings the city presented its evidence on that subject. The case was closed on July 19, 1932. At these hearings the commission introduced no evidence of its own as to the company's revenues, expenses or net earnings. Under date of March 8, 1933, however, and without any notice to the company, the commission entered an order putting in evidence as commission's exhibits numbered 1, 2, 3 and 4, respectively, the annual reports covering the entire operations of the company, which had been filed by it with the commission for

the calendar years 1928, 1929, 1930 and 1931, respectively. Notice of this order was not given to the company until the time that it was served with a copy of the final rate order of March 10, 1933.

The commission, when it entered its order as to the annual reports, had in its possession the annual report of the company for the calendar year 1932, which had been filed on or before March 1, 1933. It failed to include this report among those put in evidence, and refused to do so when this was specifically requested by the company. (R. 85, 109-11).

Under date of March 10, 1933, the commission entered its final rate order in this proceeding. That order was accompanied by a written opinion. (R. 85-99, 118-24). The order found that the rates fixed by the Lima ordinance of March 19, 1928 were insufficient, unjust and unreasonable rates, but fixed rates to be charged for service in Lima during the ordinance period, averaging about 13½% below those that the company had been charging. These rates are as follows: (Commission order, p. 1) (R. 86).

400 cubic feet or less used per month, $1.00.

Next 9600 cubic feet used per month, $.95 per thousand cubic feet.

Over 10,000 cubic feet used per month, $.75 per thousand cubic feet.

Penalty for non-payment of bill within ten days after receipt of bill, $.05 per thousand cubic feet.

The rates fixed were made retroactive to the effective date of the ordinance, which is probably April 19, 1928. The commission ordered the company to refund to its customers in Lima the difference between the amounts actually collected by the company for service during the ordinance period and the amount that would have been charged for such service if the rates fixed by the commission had

actually been in effect during that time. After careful calculation, the company estimates that the refunds ordered exceed $330,000.00 exclusive of interest.

On March 18, 1933 the company filed with the commission its written application for a rehearing. In addition to pointing out specifically many errors and irregularities that the company believed rendered the order unlawful, the company asked that the commission permit it to show the facts as to its decreased revenues and net return from service in Lima for the year 1932 and the then current year, that the commission permit it to show the exact effect of the application of the commission rates upon its revenues for so much of the ordinance period as had expired, that the commission base its rate order on the competent evidence in the case, and that the commission either exclude all the annual reports which the company had filed with it or put in evidence the 1932 annual report. By an order entered March 22, 1933, the commission denied these requests and denied the application for rehearing. (R. 100-11.)

The company, thereupon, filed, under General Code of Ohio, sections 544-5, its petition in error in the Supreme Court of Ohio, and asked a stay of the commission order until a judicial review of the proceedings could be had.

The Evidence.

The record before the commission consisted of 1261 pages of oral testimony, of 46 exhibits introduced by the company, of 16 exhibits introduced by the city and of 8 exhibits introduced by the commission. Much of this testimony and many of these exhibits are applicable to the question of valuation. This is true of the major part of the testimony contained in the first 1000 pages of the transcript of evidence, and of much of the data shown in Company Exhibits 1, 3 to 29, both inclusive, F and G, 100 and 101, in City Exhibits 1 to 7, both inclusive, 11, and A-4, and in Commission Exhibits 1, 2, 3 and 4. In view of

the fact that no appeal was taken from the final valuation order and that the company appealed the validity of the final rate order to the state supreme court and not to a federal equity court, it is unnecessary here to review this evidence as to valuation. Under the statute (General Code of Ohio, section 547), the action of the commission on that phase of the controversy was not subject to review in such an appeal.

Generally speaking, the facts which are susceptible of definite ascertainment are not in dispute. There is little material contradiction in the factual evidence. The questions presented for decision are generally questions of law, or at most, mixed questions of law and of ultimate fact as the latter may be deduced from the evidentiary facts shown. The untenable result reached by the commission was predicated principally on the commission's disregard of the facts, on its mistaken calculations, on findings unsupported by evidence, and on its refusal to follow applicable and controlling legal principles. The state supreme court in upholding the order necessarily approved or disregarded these errors and this arbitrary and unsupported action of the commission. It, likewise, failed and refused to give the company that independent review of the law or the facts, which due process requires.

In the following summary of the evidence applicable to the cost of rendering the service given, and the return earned therein, the evidence, the commission order, and the proceedings before the state court will be considered under what are deemed to be appropriate headings.

History of the Company.

This company was organized under the laws of the state of Ohio late in 1924. Shortly after its organization it acquired, under authorization of the commission given in

cause No. 3330, gas utility properties used in serving Lima and three other Ohio communities. These properties were acquired at a price fixed by the commission after an appraisal by it of the properties to be purchased. (R. 396, 406, 553-4). The amount and the kind and character of the securities issued and sold to provide funds for the payment of the acquired properties were fixed by the commission. (R. 553-4, 396-9). The company commenced its utility operations on December 1, 1924. (R. 129). From time to time since that date it has, with the approval of the commission, acquired additional utility properties; and has from time to time made additional capital investment in improving and extending its plants used for service in Lima and elsewhere. (R. 528A, 528B, 157, 304-9). It now serves eleven communities. Part of these are served with natural gas, and part with a mixed gas. (R. 129, 141, 783-4). In 1931 the company's revenues in Lima represented approximately 63.9% of its utility revenues, and about 55.6% of its customers were there located. Prior to the acquisition of additional properties in 1930 and 1931, a considerably higher proportion of its customers and revenues were in Lima. (R. 530, 636-816).

The general management of the company was shown to be in the hands of capable men having long experience in the gas utility business. Until his death in 1931, Mr. Emmett R. Curtin was president of the company, and the man in active charge of its business. During his entire business life he had been active in the operation of gas properties in Ohio, and his actual experience covered all phases of the business. (R. 166-7, 245-7). Mr. Frank L. Pringle, comptroller (since March, 1934, the vice-president and general manager) of the company, has been associated with the company, and predecessor companies serving gas in Lima, for more than twenty years. The records of the

company are under his supervision and he has had active charge of the accounting records of the company since its formation. (R. 125-6, 316). Mr. R. L. Lynch is the general superintendent of the company in charge of the manufacturing plant in Lima and of the distribution of gas in that city. His experience in these phases of the business of this company extend over a seventeen-year period. (R. 165-6, 279).

Source of Gas Supply.

Lima is one of the communities served with mixed gas. When gas service was first established in Lima many years ago, artificial gas was furnished, but only the business district of the city was supplied. Later, with the development of gas fields in adjacent Indiana and Ohio territory, natural gas service, primarily for residential consumers, was inaugurated by a separate company. Subsequently, both these companies came under the same general management and control. Prior to the sale of their properties to the interests organizing the West Ohio Gas Company, neither of these companies was in any way connected with those interests. (R. 146-9, 206-9, 251-4).

All the adjacent gas fields proved erratic producers and short lived. Pipe lines were frequently being changed from one field to another. (R. 245-7, 251). Shortly before the World War all sources from which it was then practicable to obtain a natural gas supply for Lima became inadequate or entirely non-productive. Among other steps thereafter taken was the construction of new units for producing manufactured gas. In order to maintain the heating content of the manufactured gas at the customary standard, it was necessary to enrich with natural gas the blue or water gas produced. It is undisputed that sufficient natural gas could not be obtained to supply natural gas at retail and also to enrich the manufactured gas. The

gas shortage was especially acute during the winter months. To meet this situation and enable it to render adequate service, the company, shortly after it acquired these properties, applied to the commission for authority to discontinue the service of natural gas in Lima. After due inquiry by the commission, this application was granted. (R. 572-4, 206-9).

The company does not control, and never has controlled, any source of natural gas supply. It has no means of securing such a supply from any company, directly or indirectly affiliated with it. It must obtain natural gas wherever it can secure it in the open market. During many years there have been repeated occasions of shortage of supply, and instances where the parties from whom gas was being secured threatened to discontinue the supply entirely. This was the situation that existed in 1929 when the company entered into a five-year contract for the natural gas needed for enriching purposes. (R. 526-7, 217-9, 224-5, 255-6, 261, 268-70, 411).

The fact is not shown by the evidence in this case, but it is true, as claimed by the commission, that at the present time there are large quantities of natural gas being transported into Ohio. This situation exists because of the very recent development of the Texas and other gas fields and the construction of long distance pipe lines completed late in 1931 or in 1932. This situation is the exact opposite of that which obtained prior thereto, and at the time of the company's contract for gas.

In, and long prior to, 1928, and thereafter until recently, it has been impossible to procure enough natural gas to serve Lima on a natural gas basis, and it has been exceedingly difficult to secure contractual assurance that the amount would be supplied which was needed for use in connection with manufacuring gas for service in Lima. In 1928 the company had a contract for procuring natural

gas from the Ohio Fuel Gas Company, which contract was for a period ending shortly after the end of that year. Throughout that year the company tried to arrange to procure gas at a better price and from other sources, but was wholly unable so to do. (R. 409-11). [See also *West Ohio Gas Company v. Public Utilities Commission*, 42 F. (2d), 899 (1928).] The company was forced, therefore, to renew its contract with the Ohio Fuel Gas Company for gas, and to pay the price demanded by that company for its product. The price under such contract was 55 cents per thousand cubic feet. (R. 259).

LIMA ACCOUNTING DISTRICT OF THE COMPANY.

At the present time the company serves gas to eleven communities. The company accounting records are kept in accordance with the uniform classification of accounts for gas utilities, prescribed by the Ohio commission. (R. 316, 339). Accounts covering the revenues and expenses from gas utility service are kept by accounting districts. Generally speaking, each municipality is a separate accounting district, but if there is some service given to consumers residing in the immediate vicinity of the municipality, the revenues from, and the cost of, such service are included in the revenues and expenses for the district. This is the situation in reference to accounts for Lima. The Lima district accounts cover not only service rendered within the city itself, but that given to consumers in the immediately adjacent territory, which includes a small unincorporated community known as Cridersville, where about 120 customers are served. (R. 319). Revenues from such service outside the city limits constitute slightly over 2% of the total revenues for the Lima district. The rates in this rural territory are the same as those in Lima. It is evident, therefore, that the net earnings for the Lima district are not greatly different from those secured within

the Lima city limits. For this reason, the company in presenting its exhibits as to the net earnings included all the figures for the Lima district. Since the valuation by the commission only covered property used and useful within the city of Lima, the addition to net earnings was prejudicial to the company. The company felt, however, that since the difference was too small to change the results, it was preferable to present the figures as disclosed by the actual accounts. In view of the fact that the commission in its order used revenue and expense figures applicable to the city of Lima alone, it became necessary in this brief and argument to make such adjustments as are required to put on a basis for comparison, the figures presented by the company in its exhibits.

THE COMPANY'S REVENUES FROM GAS SERVICE IN LIMA.

These were shown by the company in detail for the Lima district for the years 1927, 1928, 1929, 1930 and 1931. (R. 529-48). They were likewise shown for the twelve-month period ending March 31, 1928. (R. 548-9).

The revenue figures submitted by the company were taken from the books of the company, and were undisputed. They showed that from gas utility service in the Lima district the company obtained $492,945.07 in 1927; $511,105.08 in 1928; $511,853.64 in 1929; $491,255.46 in 1930, and but $457,775.74 in 1931. (R. 530).

Neither the city nor the commission offered any evidence during the hearings as to company revenues. In so far as the company's annual reports, which the commission ordered put in evidence on March 8, 1933, disclose revenue figures for the Lima district, such figures accord with those shown in the company's exhibits.

The commission in its order found that the average annual revenue derived by the company from gas utility service in Lima was $482,904.50 during the four-year

period ending December 31, 1931. The commission did not disclose how it obtained this figure. Certainly there is nothing in the evidence from which that figure could be arrived at. Company Exhibit 104 discloses for this four-year period an average annual revenue in the Lima district of $492,997.48. (R. 530). The commission revenue figure of $482,904.50 for Lima service alone is 97.95% of the company average of $492,997.48 for the Lima district. This difference of 2.05% is an approximately accurate measure of the proportion of Lima district revenue that is annually derived from service rendered outside the city limits of Lima. We, therefore, used it in the brief before the state court, and will use it here, as the measure for adjusting the company exhibit as to earnings, so that the data there contained may be readily compared with the commission findings.

So adjusted, the company exhibit as to revenues shows that in 1927 the company obtained $482,839.72 from gas utility service rendered within the city of Lima; $500,627.43 in 1928; $501,360.64 in 1929; $481,184.72 in 1930; and $448,391.34 in 1931. By eliminating the 1932 annual report of the company and by refusing to give the company an opportunity to show in evidence its revenues from Lima service during that year, the commission kept out of evidence the fact that revenues for 1932 were materially lower.

The city's own evidence showed the fact that revenues under the ordinance would not have covered operating expenses. (R. 586-9, 450).

The Cost of Rendering Gas Service in Lima.

The cost of rendering gas utility service in the Lima district was shown by the company for the same periods for which revenues were shown. (R. 529-48, 316-385). Mr.

Frank L. Pringle, comptroller for the company, testified to the fact that these expenses were those shown on the books of the company, except as to certain adjustments in the item of reserve for amortization of pipe line and as to retirement allowance for 1931. The nature of these expenses, the basis of allocation for such of them as were a part of expenses incurred for the company as a whole, and the propriety of the adjustment of the two items referred to were fully explained by him. He was subject to cross-examination by the commissioners and by counsel for the city. His testimony showed that all expenses which were incurred solely in connection with gas utility service in the Lima district were charged *directly* to that service, and no apportionment of such expenses between communities served was required. Such expense as could not be charged direct, but was incurred in common for all districts was apportioned on such basis as the accounting officers of the company deemed most equitable. For example, commercial expense in connection with rendering bills, for the entire company, which in 1931 was incurred in the central office at Lima, was divided on the basis of accounts served. (R. 543). Allocation of that part of general and miscellaneous expense that was a joint expense for the entire company was made on a gross revenue basis. (R. 545-8).

The operating expenses as shown by Company Exhibits 104 and 105, when made applicable to the city of Lima alone by the 2.05% reduction heretofore explained, are $396,002.64 for 1927; $382,992.75 for 1928; $402,743.55 for 1929; $381,733.20 for 1930; $369,308.22 for 1931; and $399,523.29 for the twelve-month period ending March 31, 1928.

The city introduced an exhibit as to operating expenses in connection with Lima gas service. (R. 577-616). That exhibit contains, on pages 26 to 67, elaborate calculations

for allocating to the city of Lima a portion of distribution, commercial, new business and general and miscellaneous expense for the Lima district. While the percentages there allocated to Lima are somewhat less for the items analyzed than the 2.05% we have here adopted, the difference is only about one-half of one per cent. of the total district expenses for such items, and is negligible as far as affecting the result in this case.

The various studies in City Exhibit A-3 that purport to show the cost of rendering gas service in the city of Lima are divided into two principal divisions. In neither of these are the company's actual operating costs used for but a part of the items of expense.

In the first division of that exhibit (pp. 1-13; 26-31) it was assumed that natural gas had been secured by the company at a cost of 35 cents a thousand cubic feet. This part of the exhibit disregards the fact that the actual cost was and is 55 cents per thousand cubic feet. It was properly ignored by the commission and state court in reaching its decision; and consequently has not been included in the printed record here. In the second division of the exhibit (pp. 14-25) the city presented its evidence as to cost of service when natural gas purchases were taken into account at their actual cost of 55 cents per thousand cubic feet. (R. 582-9).

When adjustment is made to limit the company's expense figures to expenses for the city service alone, the city's evidence as to distribution expense, commercial expense, new business expense, indirect charges to construction, and uncollectible accounts are substantially in accord with that of the company. This appears clearly from the following tables which show for the calendar years 1929, 1930 and 1931 a comparison between the evidence of the company and the city as to such of the items of expense above referred to as were materially reduced in the com-

mission order. Comparative data for the calendar year 1928 is not available from the record because the city only shows the last nine months of that year:

Distribution Expense

Year	Company Exhibit 104, p. 1* (R. 530)	City Exhibit A-3, pp. 22, 23 & 24 (R. 587-9)
1929	$42,047.45	$41,728.45
1930	37,460.04	36,602.29
1931	40,878.89	39,240.83
	Commercial Expense	
1929	$21,881.62	$21,707.67
1930	20,405.83	20,223.84
1931	19,069.56	18,838.48
	New Business Expense	
1929	$13,527.79	$13,420.25
1930	13,561.56	13,440.61
1931	10,923.76	13,457.80

The item of general and miscellaneous expense shown in the city exhibit is substantially below that shown by the company. This difference is due to the elimination in the exhibit of all rate case expenditures and all moneys paid by the company to its parent corporation for services rendered by that company. The city has made no showing whatsoever as to any impropriety in, or lack of necessity for, these expenses. There is none shown in the record. The only justification offered for the disregard of these costs was the bald assertion by its witness, H. R. Allensworth, that "such charges have no proper place in expense accounts upon which the fairness of rates to consumers are to be decided." (R. 454-5). The inaccuracy of Mr. Allensworth's observation as to the law on that matter

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* NOTE: Adjusted to city of Lima service by taking 97.95% of the expense of the Lima district service.

will be hereafter discussed. It should, however, be here pointed out that the company, in order to meet the possible objection that it had failed to show that its parent company was not making an undue profit on services performed for it and had, therefore, failed to comply with the requirement laid down by this court in *Smith v. Illinois Bell Telephone Company,* 282 U. S. 133 (1930), explained fully in the record the nature of, and the necessity for, such services as had been rendered to it by its affiliate, and showed that such of those services as were charged for at all were billed on an actual, or less than actual, cost basis. (R. 350-3, 382-5, 413-6, 424-5). See also: City Exhibit A-1 prepared by Mr. Pringle at the request of the city. (R. 576A).

In the city's Exhibit A-3 federal income tax and Ohio excise tax items were materially reduced through the device of figuring tax payments not on the basis of actual taxes but on the basis of what amounts would have been paid if the revenues of the company had been only such amounts as were necessary to pay the limited operating expenses taken into account by the city and leave the company a five per centum annual return on the commission valuation. Real and personal property taxes were reduced several thousand dollars a year below those shown on the company accounts. The commission found all taxes to be substantially as claimed by the company, and the state court made no change in this finding. In the city exhibit retirement allowance was placed at $35,579.32 per year instead of the $52,539.40* set up by the company. No allowance whatsoever was made for the item of pipe line amortization reserve.

The operating expenses as set forth in City Exhibit A-3 (R. 577-616) are approximately $60,000 a year less

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*Note: This figure is 97.95% of the Lima district figure of $53,639.00.

than those shown by Company Exhibit 104, adjusted as hereinbefore explained, to the city of Lima alone.

The commission submitted no evidence on the subject.

Rate of Return Necessary.

On this subject the company submitted an exhibit in which it showed the actual cost to the company of moneys for capital purposes raised by the issuance and sale of bonds and preferred stocks. (R. 551-2). The issuance of all of these securities were authorized by the commission during or since 1924. The bonds authorized were thirty-year bonds. This exhibit shows that that portion of the capital of the company which has been obtained by the sale of bonds is actually costing the company 7.07% per annum, and that that portion which has been raised by the sale of preferred stock is costing 8% per annum. This exhibit was fully explained by the comptroller of the company, who also testified as to the widely scattered territory in which holders of these securities resided. (R. 389-95, 513-4).

The company also submitted in evidence the commission rate order in cause No. 179, fixing gas rates to be charged by the company in serving consumers in Lima, and entered by the commission on April 25, 1925, wherein the commission found that the rate of return for the company should be at least 7.8% per annum, and that any lower rate would be unreasonable. (R. 521).

The city offered no evidence as to a fair rate of return except the unsupported opinion of its witness H. R. Allensworth that "it is my opinion that the fair rate of return on this property *will be found* to be 5 per cent, or I should say not more than five per cent." (R. 443-5).

The commission submitted no evidence on the subject.

The Value of the Company's Property Used in Serving Consumers in Lima.

The valuation of the property used by the company and useful in rendering gas utility service within the city of Lima has been fixed by the commission as $1,901,696.26 in its final valuation order entered in this cause on January 27, 1932. (R. 82-5). This valuation covers only that portion of the company's property used and useful for service to consumers within the city limits of Lima, and does not include property used and useful for service to consumers residing within the Lima district, but outside the city limits. The amount fixed is the exact sum recommended by the commission's engineering staff, after making eliminations for alleged excess capacity. (R. 627-35, 301). It includes nothing for going value. (R. 303). No appeal having been taken from this order, it was impossible in the rate appeal for the company, under the peculiar provisions of the Ohio law, to challenge in the state courts the insufficiency of the valuation. It is unnecessary, therefore, for us to outline the evidence as to valuation. We desire to point out, however, that we are confident that any analysis of the valuation will clearly show that item after item was given a value less than a reasonable minimum and that the final result reached is a far lower one than can be legally justified. The amount of value allowed cannot be used, as witness Allensworth in his testimony and the commission in its order endeavored to do, as a justification for allowing an unreasonably low rate of return.

The inventory date for all appraisals submitted was March 31, 1928. The company submitted in evidence exhibits showing by years the net amount of capital additions made by the company during each year of its operations to and including 1930. These amounts were determined by subtracting from the total capital expenditures

for each year the capital retirements for such year. (R. 528B). The net capital additions for the Lima district were $17,657.58 for 1928; $50,822.93 for 1929; and $28,125.34 for 1930. These capital additions were ignored by the commission in determining the rate of return that would be earned by the company under the rates fixed.

The trend of costs in the construction of gas properties during the ordinance period was shown by competent evidence. (R. 554A).

THE COMPANY'S NET EARNINGS FROM GAS SERVICE IN LIMA.

The company's revenues, expenses and net earnings from utility operations in the Lima district for the years 1927 to 1931, both inclusive, are shown in the record (R. 529-48) to be as follows:

Year	*Revenue*	*Expenses*	*Net Earnings*
1927	$492,945.07	$404,290.60	$ 88,654.47
1928	511,105.08	391,008.42	120,096.66
1929	511,853.64	411,172.59	100,681.05
1930	491,255.46	389,722.51	101,532.95
1931	457,775.74	377,037.49	80,738.25

When the figures set out in that exhibit are adjusted in the manner hereinbefore described, pp. 13-4, *supra*, so as to reflect the approximate revenues, expenses and net earnings from utility operations within the city of Lima alone, the foregoing table is changed as follows:

Year	*Revenue*	*Expenses*	*Net Earnings*
1927	$482,839.72	$396,002.64	$ 86,837.08
1928	500,627.43	382,992.75	117,634.68
1929	501,360.64	402,743.55	98,617.09
1930	481,184.72	381,733.20	99,451.52
1931	448,391.34	369,308.22	79,083.12

Taking as a rate base the valuation fixed by the commission in this case (without augmentation for net addi-

tion subsequent to 1928), the rate of return earned *under existing rates* during each of the years in question was as follows:

Year	*Property Value*	*Net Earnings*	*Per Centum Rate of Return*
1927	$1,901,696.26	$ 86,837.08	4.5%
1928	1,901,696.26	117,634.68	6.2%
1929	1,901,696.26	98,617.09	5.2%
1930	1,901,696.26	99,451.52	5.2%
1931	1,901,696.26	79,083.12	4.2%

The city offered no exhibit as to the net earnings of the company. Mr. H. R. Allensworth, in preparing City Exhibit A-3 (R. 577-614), assumed net earnings of $94,400.98 or 5% on a property value slightly lower than that fixed by the commission, and "created" a revenue figure sufficient to cover only the operating expenses shown by him and the 5% return. (R. 435-7, 443). In his direct examination, however, witness Allensworth, after discussing the reductions he had made in showing the operating expenses of the company, testified that he thought it apparent from the figures *here* that *at the present rate* charged by the gas company, the company makes a 7% or 8% return on its investment. (R. 455).

The commission introduced no evidence whatsoever as to the net earnings of the company, nor any analysis of any kind as to the company's revenues or expenses.

The Annual Reports of the Company.

The 1927 annual report of the company to the commission, which was introduced in evidence by the city, and the four similar reports for the years 1928 to 1931, both inclusive, which the commission put in evidence on March 8, 1933, are the annual reports for the company as a whole that had been filed pursuant to statutory requirement and

commission order. Among other data applicable to the year reported, they disclose, pursuant to printed instructions in the reports,—the number of customers in each community where artificial gas is supplied, the number of customers in each community where natural gas is supplied, the operating expenses by accounts (combined for the entire company) in connection with the sale of artificial gas, the operating expenses by accounts (combined for the entire company) in connection with the sale of natural gas, interest paid and dividends declared, and an income statement and balance sheet for the company as a whole. In the 1931 report operating expenses for both artificial and natural gas service were combined under one heading. (R. 802-5).

The Commission Order and Opinion.

The rates fixed by the commission in this cause compare with existing charges as follows:

	Existing Rate	*Rate Fixed*	*Percentum Reduction*
400 cubic feet or less per month	$1.25	$1.00	20%
Rate per thousand cubic feet for next 9,600 cubic feet per month	1.05	.95	9.5%
Rate per thousand cubic feet for next 15,000 cubic feet per month	1.00	.75	25%
Rate per thousand cubic feet for all gas over 25,000 cubic feet per month	.75	.75	.....
Penalty per thousand cubic feet for non-payment of bill within ten days after due	.10	.05	50%

The order provides that the rates fixed by the commission therein are to "remain in force and effect for the period fixed and prescribed by said Ordinance." They have, therefore, been made retroactive over the past five years, and for each of the five years without regard to the actual effect of the rates in each such year. The commission further ordered the company to refund to its consumers the difference between amounts collected during the ordinance period and the sums that would have been collected had the company charged the rates fixed by the order.

On the face of the original opinion of the commission accompanying the rate order, there was an error in adding the amounts set forth as the items of operating expense taken into account. The total was stated in the order to be $305,686.88. The amounts listed in fact totaled $301,920.92. This we pointed out in our initial brief to the state court. Thereupon the commission under date of May 19, 1933, without notice to the company and without correcting the mathematical errors that the commission accountants had made in figuring certain of the items themselves (which facts had also been pointed out), entered a *nunc pro tunc* order correcting the error in addition and changing certain statements as to the percentages of return earned under the commission's rate.

The commission opinion, as corrected by the *nunc pro tunc* order, states that operating expenses of the company were considered in an average amount of but $301,920.92 a year for the years 1928 to 1931, both inclusive, and that when operating expenses were limited to that amount the return on the rate base would average 6.65% a year for those four years under the rates fixed. (R. 118-9). The actual operating expenses for such four-year period averaged $384,194.43 a year, p. 15, *supra.*

The commission opinion outlines the method by which the commission had determined the amounts it allowed for distribution expense, commercial expense, and general and miscellaneous expense. That method was the development of customer averages from the annual reports of the company. (R. 93). The opinion gives no clew as to how the commission had reached its conclusion as to revenues or as to net earnings under the rates fixed.

Studies made by the company as to these averages and assumed revenues revealed that they were inaccurately developed and erroneous. The commission and its staff refused any additional information as to the method pursued in working out these items of expense on this alleged return, and consequently it was necessary to fall back upon the laborious process of trial and error in attempting an analysis.

The analysis, however, showed clearly that incorrect customer averages had been used; that a very substantial part of the general and miscellaneous expense items had been overlooked; and that the revenues under the commission rates had been erroneously calculated. These errors were pointed out in our initial brief to the state court. Counsel for the commission admitted certain of the omissions and errors; and, in tables set out in their reply brief, gave the first explanation of how the commission accountants had developed their figures. Upon analysis, these tables revealed further errors that the accounting experts had made.

To avoid useless controversy over pure mistakes of calculation, we then worked out corrected tables with counsel for the commission, and these were set forth in our reply brief. The tables showed the true results obtained by applying the commission theory of expense allowances without the intervention of mathematical errors

and oversights. They also showed the revenue obtained by applying the commission rates to actual gas consumption in Lima for the four-year period.

About seven months after the case was first argued, the state supreme court ordered a reargument. In the meanwhile, the assistant attorney general who had briefed and first argued the case, had resigned. The new assistant, who presented the second argument, later filed a supplemental brief in which he claimed two changes should be made in the expense figures shown in the corrected tables: (a) the "cost of gas sold" should be reduced below the figure in the corrected tables, and (b) rate case expense should be eliminated. There was no basis for claim (a) except a failure to take the time to study Company Exhibit 104 and the facts outlined in our reply brief. That exhibit and statement showed plainly that counsel's claim of reduction was unsupported by fact. As to his second claim, the state supreme court has recognized that his position as to the disallowance of the rate case expense is untenable.

In order that this court may have before it the information as to the nature of these errors and also the evolution of the tables correcting them (the accuracy of which tables may be checked from the figures in the record), those portions of the briefs in the state court that deal with the necessary arithmetical corrections, are reproduced in an appendix to this brief, marked "Appendix A," pp. 165-90, *infra*. We deem this the clearest method of making available to this court the information as to the nature of the errors in calculation, the claims advanced, and the corrections required. The fact that such errors unquestionably exist and affected the commission's action is an important factor to be kept clearly in mind in considering this case.

The information in Appendix A, p. 183A, *infra,* shows clearly that, if the rate case expense be amortized over the ordinance period, the expenses as set forth in the commission's opinion would, except for the fact of erroneous information supplied by its accountants, have been as follows:

Operating Expenses.	*City of Lima Commission Average 1928-1931, both inclusive.*	
Gas Produced and Purchased	$146,574.92	
Distribution Expenses	34,428.00	
Commercial Expenses	19,719.00	
New Business Expenses	5,000.00	
General and Misc. Expenses	45,025.00	
Indirect Charges to Constr.	3,804.00	(Red)
Retirement Allowance	24,518.00	
Real and Personal Prop. Taxes	22,797.25	
State of Ohio—Excise Tax	7,114.25	
Tax of Ohio Pub. Util. Com.	278.25	
Federal Income Tax	8,504.00	
Uncollectible Accounts	2,445.75	
	$312,600.42	

The corrected revenue tabulation shows revenues under the commission rates averaging $416,225.04 per year for the first four years of the ordinance period. (Appendix A, pp. 179A, 183A, *infra*). Subtracting from this the aforementioned $312,600.42 of operating expenses leaves $103,624.62 as the average yearly net earnings for the four years, if the operating expenses ignored by the commission are left out of account.

This is but 5.45% on the rate base instead of the 6.65% which the commission asserted it had allowed.

The rate fixed was to apply throughout all of 1932. Nevertheless in making its order the commission disregarded what the evidence indicated as to the probable earnings in 1932. That evidence disclosed that revenues and net earnings for 1931 were far below an average for the four years 1928 to 1931. (R. 530). The commission had in its files the 1932 annual report of the company which showed clearly that revenues and net earnings were low for 1932. The commission had no hesitancy in using all the other annual reports except the one for 1932. (R. 85, 93). It did not use the one for 1932. It refused to give the company a rehearing so that the company could present evidence of the exact facts as to 1932 earnings. (R. 110-1).

Even if it be assumed that net earnings for 1932 were as high in 1932 as in 1931, the return under the commission rates and the commission theory of determining operating expenses, average but 5.28% per year for the five-year period for which the rates were made effective.

The Judgment and Opinion of the Supreme Court of Ohio.

The purported statement of facts as set forth at the beginning of the court's opinion is taken almost verbatim from the statement of the case as set forth in the initial brief filed by counsel for the commission. But few of the facts alleged therein were supported by any reference to the record and many of the statements are entirely at variance with what the record shows. These misstatements of fact were specifically called to the court's attention in our reply brief and in oral argument. References were given to the record to support each of our claims of misstatement. Counsel for the commission did not debate the fact that their initial statement was inaccurate. Neverthe-

less, the state court in its opinion has adopted that inaccurate statement as its statement of facts. In "Appendix B" to this Brief and Argument, we have outlined the facts of record relating to the more important challenged allegations in the court's statement of facts. (See pp. 191-201, *infra*).

Likewise the statement of issues as set forth in the court's opinion is taken practically verbatim from the statement of issues as set forth in the original brief filed on behalf of the commission. That statement ignores any direct reference to the very essential issue that the rate order is void for lack of due process because not supported by or warranted under the competent evidence in the case.

The court's opinion is premised upon the propositions that the commission should be sustained in the various eliminations of operating expenses that it made; that under such circumstances the rate order allowed the company a return of at least approximately 6% per annum for the rate period; that a 6% annual return for the period from early in 1928 to early in 1933 was sufficient to avoid confiscation; and that, therefore, the commission's order should be upheld. In its conclusion that the rate order of the commission produced a 6% annual return, even after more than $71,500.00 of operating expenses were eliminated, the court completely disregarded the necessary result of correcting admitted errors in calculation.

SPECIFICATION OF ASSIGNED ERRORS INTENDED TO BE URGED.

The assignment of errors contains twenty-seven paragraphs (R. 58-63). These support the basic proposition that the rate order appealed from, and the judgment of the Supreme Court of Ohio upholding that order, deprive the company of its property without due process of law in vio-

lation of section one of the fourteenth amendment to the constitution of the United States.

As heretofore stated, no issue of valuation is involved. The substantive issue is whether the rates fixed by the commission were confiscatory for the ordinance period. The issue as to lack of due process in the proceedings themselves centers around the contentions that the commission improperly used annual reports that were not in evidence, that it ignored the evidence as to operating expenses, that it denied the company a rehearing to which it was entitled as a matter of right, and that the state supreme court did not make that independent judicial review of the law and the facts which due process requires in confiscation cases.

All the errors assigned are to be urged. In the argument they have been discussed under the various broad issues which they support, and they are here summarized under the general headings that will be used in the argument:

The State Supreme Court Erred in Not Holding that the Rate Order was Void because the Commission had Predicated the Order on Matters Not Properly in Evidence.

> *Assignment No.* 4: Error in relying upon annual reports not properly introduced in evidence.

The State Supreme Court Erred in Affirming the Finding and Order of the Commission which fixed Rates upon the Basis of an Arbitrary Disregard of Operating Costs incurred by the Company in Rendering the Service.

> *Assignment No.* 7: Error in disregarding a substantial part of the cost of the gas purchased or produced in connection with rendering the service.

Assignment No. 8: Error in disregarding a substantial part of the distribution costs incurred in rendering the service.

Assignment No. 9: Error in disregarding a substantial part of the commercial costs incurred in rendering the service.

Assignment No. 10: Error in disregarding a substantial part of the new business costs incurred in rendering the service.

Assignment No. 11: Error in disregarding a substantial part of the general and miscellaneous costs incurred in rendering the service.

Assignment No. 12: Error in requiring that rate case expense be amortized over a six-year period.

Assignment No. 13: Error in disregarding the fact of increased excise taxes payable by the company after 1931.

Assignment No. 14: Error in taking into account as an operating expense an inadequate allowance only for retirement reserve.

Assignment No. 15: Error in disregarding entirely as an operating expense any amount for amortization of pipe line.

Assignment No. 16: Error in allocating certain expenses incurred by the company in rendering service.

Assignment No. 22: Error as to burden of proof as to necessity of operating expenses in rendering service.

Assignment No. 23: Error in finding that there was any evidence warranting the elimination of items of operating expense in determining net return.

Assignment No. 24: Error in invading the domain of management and interfering with freedom of ownership to control and operate property used in rendering service.

Assignment No. 25: Error in disregarding, and not according due weight to, competent and credible evidence.

The State Supreme Court Erred in that it Did Not Find that the Commission, in Computing the Return Earned by the Company, Failed to Calculate Accurately what the Revenue of the Company would be for the Ordinance Period either under the Existing Rates or under the Rates Provided in the Rate Order.

Assignment No. 6: Error through failure to calculate accurately the revenues under rates fixed by commission.

Assignment No. 2: Error through failure to determine correctly the earnings under existing rates.

The State Supreme Court Erred in that it Upheld a Rate Order under which the Company would Not have Earned a Compensatory Return. Even Existing Rates Did Not Give the Company a Compensatory Return during the Ordinance Period.

Assignment No. 1: Error in upholding rate for Lima service fixed by commission order.

Assignment No. 2: Error in not finding that company did not obtain a compensatory return even under existing rates.

Assignment No. 19: Error in holding that a return of even less than 6% per annum during the rate period would be adequate.

Assignment No. 20: Error in finding that the rates provided for by the commission order would yield a compensatory return for the rate period.

The State Supreme Court Erred in Not Finding that the Validity of the Rate Order must be Determined by its Effect on Net Earnings from Year to Year; and that the Rate Order and the Order to Refund were Invalid because this Requirement had not been Complied with.

Assignment No. 17: Error in not considering downward trend of revenues and net earnings, and the effect during 1932 of the rates fixed.

Assignment No. 18: Error in not determining for each year of the rate period whether the net earnings would be sufficient to avoid confiscation.

Assignment No. 21: Error in not determining for each year of the rate period what return would be required to avoid confiscation.

Assignment No. 3: Error in upholding order to make refund of the difference between the existing rates and those provided by the rate order.

The State Supreme Court Erred in Not Holding that the Rate Order is Invalid because the Commission Refused to Grant the Company a Rehearing, Suitably Requested.

Assignment No. 5: Error in refusing company an opportunity to put its 1932 annual report in evidence.

Assignment No. 27: Error in refusing company an opportunity to show actual effect of rate order as applied to all years, and especially 1932, and subsequently.

The State Supreme Court Did Not Make that Independent Judicial Review of the Law and the Facts which Due Process and Equal Protection of the Laws Require.

Assignment No. 26: Error in failing to make an independent review of the law applicable to, and the facts in, this case.

SUMMARY OF ARGUMENT.

I.

A Review of the Record by this Court will Disclose that the Decision of the Commission and of the State Supreme Court Disregards Controlling Legal Principles.

The commission rate order is premised upon elaborate calculations which were indulged in by the commission and which are "at war with realities." These cannot furnish an excuse for disregarding the true costs of rendering the service and the actual facts as to the inadequacy of the return.

Lindheimer v. Illinois Bell Telephone Co., 292 U. S. 151, 163-4 (1934).

II.

The State Supreme Court Erred in Not Holding that the Rate Order was Void because the Commission had Predicated the Order on Matters Not Properly in Evidence.

There has been a denial of due process of law to the company through the action of the commission in placing in evidence, *after the termination of hearings in the cause,* certain annual reports of the company, and then refusing the company any opportunity to meet any issues that might be created through the use of the reports. The record shows that the reports were ordered in evidence by the commission long after the hearings closed. This was done by an order dated three days before the rate order was entered, but not served on the company until *after* the rate order had been served on it. The commission refused the company an opportunity to explain, clarify or show the make-up of the figures and information in the reports

which the commission attempted to use as a basis for its ignoring of tens of thousands of dollars of operating expense. The figures and information were misused and misapplied by the commission. Such misapplication is the sole basis of any support for the elimination of much of the actual operating expenses that have been disregarded by the commission.

The law is clear that under the circumstances as above outlined, the reports are not properly in evidence and any attempted use thereof in the case is a denial of due process of law, rendering the order void.

United States v. Abilene & Southern Railway Company, 265 U. S. 274, 286-290 (1924).

Interstate Commerce Commission v. Louisville and Nashville Railroad Company, 227 U. S. 88, 91-4 (1913).

The Chicago Junction Case, 264 U. S. 258, 262-6 (1924).

Northern Pacific Railway Company v. Department of Public Works, 268 U. S. 39, 44-5 (1925).

Washington ex rel. Oregon R. R. & N. Co. v. Fairchild, 224 U. S. 510, 524-5 (1912).

Crowell v. Benson, 285 U. S. 22, 48 (1932).

Ohio Utilities Company v. Public Utilities Commission of Ohio, 267 U. S. 359 (1925).

III.

The State Supreme Court Erred in Affirming the Finding and Order of the Commission which fixed Rates upon the Basis of an Arbitrary Disregard of Operating Costs incurred by the Company in Rendering the Service.

The commission ignored to the extent of more than $71,500.00 a year the actual operating costs incurred by the company in rendering gas utility service to consumers

in Lima. The amount ignored is nearly 20% of the entire cost of the service. In refusing to hold that this action of the commission was illegal the state court has closed its eyes to the record.

The items of expense disregarded by the commission are of two classes,—first, those that represent actual out-of-pocket expenditures made during the period in the rendering of the service; and secondly, those for depreciation and amortization reserve which are partly actually expended for replacements within the period, and partly carried in a reserve account to protect the integrity of the investment.

The average amount of the former which the commission has disregarded is about $20,500.00 annually, if rate case expense be taken into account. This disregard of actual costs increased the apparent net return on the rate base by about 1.1% per year. When these costs are added to those used by the commission, the average net earnings of the company for the four years, 1928 to 1931, both inclusive, would be but 4.35% per annum under the commission rates.

In the latter group the average amount disregarded is $51,000.00 annually. This disregard of expense of operation increased the apparent net return on the rate base by an additional percentage of more than 2½% per year. When this additional amount is considered, average earnings for the four-year period would be less than 2% per annum under the commission rates.

In reference to the first mentioned group of expenses, the sound rule and the one uniformly laid down by the decisions is that, where payments to an affiliated company are not involved, the costs that have been actually incurred in rendering the service can not be disregarded in fixing rates unless an abuse of managerial discretion or mismanagement or fraud in making the expenditures is shown.

The state court has departed from this long established principle.

Interstate Commerce Commission v. Chicago Great Western Railway Company, 209 U. S. 108, 119-120 (1908).

Missouri ex rel. Southwestern Bell Telephone Company v. Public Service Commission of Missouri, 262 U. S. 276, 288-9, 290 (1923).

Banton v. Belt Line Railway Corp., 268 U. S. 413, 421-2 (1925).

Atchison, Topeka & Santa Fe Railway Co. v. United States, 284 U. S. 248, 262 (1932).

Brooklyn Borough Gas Co. v. Prendergast, 16 F. (2d) 615, 623 (1926).

Citizens' Gas Co. of Hannibal v. Public Service Commission of Missouri, 8 F. (2d) 632, 634 (1925).

New York & Richmond Gas Co. v. Prendergast, 10 F. (2d) 167, 181 (1925).

Chesapeake & Potomac Tel. Co. v. Manning, 186 U. S. 238, 248 (1902).

Public Utilities Commission v. Springfield Gas and Electric Co., 291 Ill. 209, 234 (1919).

People ex rel. D. & H. Co. v. Stevens, 197 N. Y. 1, 10 (1909).

Columbus Gas Light Company v. Public Service Commission of Indiana, 193 Ind. 399, 404 (1923).

Monroe Gaslight & Fuel Co. v. Michigan Public Utilities Commission, 11 F. (2d) 319, 325 (1926).

Denver Union Stock Yard Co. v. United States, 57 F. (2d) 735, 747-749 (1932).

Re Milwaukee Electric Railway & Light Co., P. U. R. 1931E 289, 296 (1931).

Recent decisions of this court holding that the foregoing rule does not apply where transactions with an affiliated company are involved, do not render the rule inapplicable to this first class of expense items disregarded in the case at bar.

Smith v. Illinois Bell Telephone Company, 282 U. S. 133, 151 (1930).

Western Distributing Co. v. Public Service Commission of Kansas, 285 U. S. 119 (1932).

Dayton Power & Light Co. v. Public Utilities Commission of Ohio, 292 U. S. 290 (1934).

Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio, 292 U. S. 398 (1934).

The commission improperly eliminated from operating expenses a part of the cost of gas produced and purchased in connection with gas service in Lima, such amount representing approximately $19,000.00 for the rate period.

Brooklyn Union Gas Co. v. Prendergast, 7 F. (2d) 628, 652, 671 (1925).

14 *Proceedings Pacific Gas Association* 124 (1922).

14 *Proceedings Pacific Gas Association* 679 (1923).

15 *Proceedings Pacific Gas Association* 387 (1924).

Brown's Directory of American Gas Companies.

The commission has acted illegally in reducing by approximately $36,500.00 the distribution and commercial expenses incurred by the company in serving gas to consumers in Lima. As a means of accomplishing this reduction, the commission attempted to allocate expenses that were direct expenses incurred in Lima and that did not involve any problem of allocation whatsoever. This is improper. The attempted reduction in these costs has not a vestige of any support except through the misuse made

by the commission of data contained in the annual reports unlawfully relied upon by it.

Wabash Valley Electric Co. v. Young, 287 U. S. 488 (1933).

Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio, 292 U. S. 398 (1934).

Northern Pacific Railway Company v. North Dakota ex rel., 236 U. S. 585, 597 (1915).

Banton v. Belt Line Railway Corp., 268 U. S. 413, 421 (1925).

Northern Pacific Railway Company v. Department of Public Works, 268 U. S. 39, 42-4 (1925).

The Minnesota Rate Cases, 230 U. S. 352, 437 (1913).

The commission cannot lawfully ignore actual costs and actual net return, or create a fictitious basis for a reduction of rates by taking into account estimated expenses and assumed earnings for past periods.

Wisconsin-Minnesota Light & Power Company v. Railroad Commission of Wisconsin, 183 Wis. 104, 105-6 (1924).

The commission arbitrarily disregarded nearly 60%, or about $35,000.00, of the expense incurred by the company during the rate period in securing new business and in retaining its existing business in Lima. The state court closed its eyes to the record when it approved this action of the commission.

Ohio Utilities Company v. Public Utilities Commission of Ohio, 267 U. S. 359, 363 (1925).

Consolidated Gas Co. v. Newton, 267 Fed. 231; 253 (1920).

Brooklyn Borough Gas Co. v. Prendergast, 16 F. (2d) 615, 623 (1926).

Monroe Gaslight & Fuel Co. v. Michigan Public Utilities Commission, 11 F. (2d) 319, 325 (1926).

Citizens' Gas Co. of Hannibal v. Public Service Commission of Missouri, 8 F. (2d) 632, 634 (1925).

New York & Richmond Gas Co. v. Prendergast, 10 F. (2d) 167, 181 (1925).

United Railways and Electric Company of Baltimore v. West, 280 U. S. 234, 249 (1930).

The commission improperly determined the amount of the general and miscellaneous expense of the company in rendering gas utility service in Lima. It arbitrarily allocated the direct general expense; it used an untenable basis of allocation for joint general expense; and it overlooked a substantial part of the general expense. The result was that about $12,500.00 of such expense was disregarded even if rate case expense be taken into account. If the state court had made an independent review of the record it would have found that there was nothing in the record to support the commission's action in reference to this item of expense.

See Argument.

The failure of the commission to take into account as an additional operating expense the increased excise tax which the company has been required to pay the state of Ohio subsequent to 1931, was erroneous. Such failure contributed to the finding of a net return in excess of the true net return earned by the company. The state court should have ruled that the commission's treatment of this expense was improper.

See Argument.

Before coming to the question of net return at all, the company is entitled to deduct from its revenues for each year, as an operating expense item, an adequate allowance for retirement reserve. In fixing this allowance the commission must be governed by the facts as shown by the evidence and cannot fix the amount at a purely arbitrary figure.

Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio, 292 U. S. 398 (1934).

United Railways and Electric Company of Baltimore v. West, 280 U. S. 234, 254 (1930).

City of Knoxville v. Knoxville Water Company, 212 U. S. 1, 13-4 (1909).

Mobile Gas Co. v. Patterson, 293 Fed. 208, 223-4 (1923).

The rate of retirement reserve claimed by the company was the rate allowed the company by this commission in several previous rate orders affecting the company. The facts in the record show the rate to be reasonable.

In re West Ohio Gas Company, 22 Ohio D. R. 121 (1925).

In re West Ohio Gas Company, 24 Ohio D. R. 527 (1926).

In re West Ohio Gas Company, 24 Ohio D. R. 535 (1926).

In re Lima Natural Gas Company, Commission Cause No. 2360.

Annual allowances at approximately the rate claimed by the company and at even higher rates frequently have been held fair and reasonable by courts, commissions and other authorities.

City of Belleville v. St. Clair County Gas & Electric Company, P. U. R. 1915F 235 (3%).

City of Winona v. Wisconsin-Minnesota Light & Power Co., 276 Fed. 996 (1921) (2½%).

City of Bellingham v. Puget Sound Power & Light Company, P. U. R. 1921E 5 (3½%).

Mobile Gas Co. v. Patterson, 293 Fed. 208 (1923) (2½% on cost new).

Re Jackson County Light, Heat & Power Company, P. U. R. 1926D 737 (2.75%).

City of Manitowoc v. Wisconsin Fuel & Light Company, P. U. R. 1927D 737 (3%).

Wichita Gas Company v. The Public Service Commission, 126 Kan. 220 (1928) (3%).

Fort Worth Gas Co. v. City of Fort Worth, 35 F. (2d) 743 (1929) (3.6%).

Saliers, "Depreciation, Principles and Application," (1923) pp. 537-9.

Depreciation Studies, Preliminary Report of the Bureau of Internal Revenue, Treasury Department, January, 1931, pp. 1-2, 29, 33.

In any event the commission could not in the light of the facts as shown by the record in this case lawfully fix a retirement reserve allowance in an amount less than the $35,579.32 advocated by the witness for Lima.

Pacific Gas & Electric Company v. San Francisco, 265 U. S. 403, 423 (1924).

Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio, 292 U. S. 398 (1934).

The action of the commission in eliminating from operating expenses the amount that the company has heretofore been authorized by it to set up in a reserve for amortization of the company's investment in its gas transmission main, is unwarranted and inequitable in the light

of the facts shown in this case and the treatment by the commission in its valuation of the company's property of the item of investment in the gas mains.

Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio, 292 U. S. 398 (1934).

IV.

The State Supreme Court Erred in that it Did Not Find that the Commission, in Computing the Return Earned by the Company, Failed to Calculate Accurately what the Revenue of the Company would be for the Ordinance Period either under the Existing Rates or under the Rates Provided in the Rate Order.

The commission based its order in this case upon an assumption that under existing rates the company obtained from gas utility service in Lima during the ordinance period an average annual revenue of approximately $483,000.00. This assumption does not accord with the facts shown by the evidence.

The commission predicated its rate order upon erroneous and excessive calculations as to the revenues that the company would have received during the ordinance period under the rates fixed.

See Argument.

V.

The State Supreme Court Erred in that it Upheld a Rate Order under which the Company would Not have Earned a Compensatory Return. To Avoid Confiscation an Annual Return Greatly in Excess of the Return that would have been Earned under the Commission Rates must be Allowed. Even Existing Rates Did Not Give the Company a Compensatory Return during the Ordinance Period.

The return that the company would receive for the ordinance period under the commission rates is confiscatory,

even if operating expenses be disregarded to the extent attempted by the commission. When actual operating expenses, which were unlawfully disregarded by the commission, are taken into account it is found that the true return is destructively inadequate.

See tables presented in Argument.

In determining a compensatory return it is essential to consider the actual effect of the rates imposed in the light of the utility's situation, its requirements and opportunities.

Smith v. Illinois Bell Telephone Company, 282 U. S. 133, 160 (1930).

Lindheimer v. Illinois Bell Telephone Co., 292 U. S. 151 (1934).

Wabash Valley Electric Co. v. Young, 287 U. S. 488, 501-2 (1933).

Los Angeles Gas & Electric Corp. v. Railroad Commission of California, 289 U. S. 287, 319-20 (1933).

United Railways and Electric Company of Baltimore v. West, 280 U. S. 234, 249-252 (1930).

Bluefield Company v. Public Service Commission, 262 U. S. 679, 692-5 (1923).

Ohio Associated Telephone Co. v. Geiger, 3 F. Supp. 997, 1004 (1933).

The evidence establishes that capital obtained by the company from the sale of bonds costs 7.07% per annum and that capital secured by preferred stock sales costs 8% per annum. These securities were issued under authorization by the commission given less than three and one-half years before the effective date of the rates here challenged. The past experience of companies rendering gas utility service in Lima did not enable this company to attract investors at low rates.

City of Lima v. The Public Utilities Commission, 106 Oh. St. 379 (1922).

City of Lima v. The Public Service Commission, 103 Oh. St. 501 (1921).

A public utility is entitled to a return at a higher rate than the mere cost of borrowed moneys.

McCardle v. Indianapolis Water Company, 272 U. S. 400, 419 (1926).

United Railways and Electric Company of Baltimore v. West, 280 U. S. 234, 251-2 (1930).

The return that a utility should be allowed an opportunity to earn must be sufficient to secure confidence in the financial soundness of the utility and enable it to support and maintain its credit.

Bluefield Company v. Public Service Commission, 262 U. S. 679, 693-5 (1923).

United Railways and Electric Company of Baltimore v. West, 280 U. S. 234, 249-252 (1930).

Wichita Gas Co. v. Public Service Commission of Kansas, 2 F. Supp. 792 (1933).

The essentialness of keeping fully in view the actualities of the situation in the specific case being presented, has been recently stressed again in this court.

Lindheimer v. Illinois Bell Telephone Co., 292 U. S. 151 (1934).

In giving weight to present general economic conditions the state court and the commission both lost sight of the fact that the rates in issue were being fixed for the years 1928, 1929 and 1930 as well as for 1931 and 1932.

See Argument.

Numerous decisions, many of them covering rates attempted to be fixed for at least a part of the period covered by the rate ordinance in the case at bar and involving utilities larger, and with opportunities to secure money upon terms decidedly better than those which the company in this case could possibly have, are to the effect that the return allowed should be 7½% or 8% if confiscation is to be avoided.

Wichita Gas Co. v. Public Service Commission of Kansas, 2 F. Supp. 792, 810 (1933) (8%).

Denver Union Stock Yard Co. v. United States, 57 F. (2d) 735, 745, 754 (1932) (7½%).

United Fuel Gas Co. v. Public Service Commission of West Virginia, 14 F. (2d) 209, 212 (1926); aff. 278 U. S. 322 (1929) (8%).

New York Telephone Co. v. Prendergast, 36 F. (2d) 54, 67-9 (1929) (7% for telephone companies is proper even though gas and electric companies entitled to 8%).

Interborough Rapid Transit Co. v. Gilchrist, 26 F. (2d) 912, 924-5 (1928) (8%).

Brooklyn Borough Gas Co. v. Prendergast, 16 F. (2d) 615, 622, 638 (1926) (8%).

Kings County Lighting Co. v. Prendergast, 7 F. (2d) 192, 194-5, 218; aff. 272 U. S. 579 (1926) (8%).

New York & Richmond Gas Co. v. Prendergast, 10 F. (2d) 167, 186-7 (1925) (8%).

Southern Bell Tel. & Tel. Co. v. Railroad Commission of South Carolina, 5 F. (2d) 77, 88-89 (1925) (8%).

Brooklyn Union Gas Co. v. Prendergast, 7 F. (2d) 628, 672 (1925) (8%).

Consolidated Gas Co. of New York v. Prendergast, 6 F. (2d) 243, 273-4, 280 (1925) (8%).

Springfield Gas & Electric Co. v. Public Service Commission of Missouri, 10 F. (2d) 252, 255 (1925) (8%).

New York & Queens Gas Co. v. Prendergast, 1 F. (2d) 351, 370 (1924) (8%).

New York Telephone Co. v. Prendergast, 300 Fed. 822, 826 (1924) (8%).

City of Minneapolis v. Rand, 285 Fed. 818, 830 (1923) (7½%).

Mobile Gas Co. v. Patterson, 293 Fed. 208, 221 (1923) (8%).

Southwestern Bell Telephone Co. v. City of Ft. Smith, 294 Fed. 102, 108 (1923) (8%).

Brush Electric Company v. City of Galveston, 262 U. S. 443, 445 (1923) (8%).

Galveston Electric Company v. City of Galveston, 258 U. S. 388, 400 (1922) (8%).

Lincoln Gas & Electric Light Company v. City of Lincoln, 250 U. S. 256, 267 (1919) (7% to 8%).

VI.

The State Supreme Court Erred in Not Finding that the Validity of the Rate Order must be Determined by its Effect on Net Earnings from Year to Year; and that the Rate Order and the Order to Refund were Invalid because this Requirement had not been Complied with.

A commission order fixing rates for a period that is past is not enforceable except as to such years of the past period during which the utility would have earned a compensatory return under such rates. A rate order is from year to year valid or invalid depending upon whether under it confiscation results at such time.

Galveston Electric Company v. City of Galveston, 258 U. S. 388, 400-1 (1922).

Banton v. Belt Line Railway Corp., 268 U. S. 413, 418 (1925).

City of Knoxville v. Knoxville Water Company, 212 U. S. 1, 19 (1909).

Lincoln Gas & Electric Light Company v. City of Lincoln, 250 U. S. 256, 268 (1919).

Willcox v. Consolidated Gas Company, 212 U. S. 19, 54-55 (1909).

Brush Electric Company v. City of Galveston, 262 U. S. 443, 446 (1923).

Smith v. Illinois Bell Telephone Company, 282 U. S. 133, 162 (1930).

Ohio Associated Telephone Co. v. Geiger, 3 F. Supp. 997, 1004 (1933).

The refusal of the commission to take into account the situation as to 1932 renders the order void as applied to that year.

Atchison, Topeka & Santa Fe Railway Co. v. United States, 284 U. S. 248 (1932).

Dayton Power & Light Co. v. Public Utilities Commission of Ohio, 292 U. S. 290 (1934).

The refund order is likewise invalid as applied to the past years because of the failure of the commission to observe this principle.

See Argument.

VII.

The State Supreme Court Erred in Not Holding that the Rate Order is Invalid because the Commission Refused to Grant the Company a Rehearing, Suitably Requested.

The commission arbitrarily denied the company an opportunity to show on rehearing the results of its opera-

tions in Lima during 1932 and the first part of 1933. Such denial constitutes reversible error.

Atchison, Topeka & Santa Fe Railway Co. v. United States, 284 U. S. 248, 260-2 (1932).

The introduction by the commission, after the termination of the hearings, of the company's annual reports for the years 1928, 1929, 1930 and 1931, its refusal to give the company an opportunity to be heard in reference to these reports, and its refusal to include the 1932 report, constitute reversible error.

See Argument.

VIII.

The State Supreme Court Did Not Make that Independent Judicial Review of the Law and the Facts which Due Process and Equal Protection of the Laws Require.

The judicial inquiry into the commission's order to which the company was entitled on its appeal to the state court was an independent review of both the facts and the law. The fourteenth amendment of the federal constitution guarantees the company such a judicial investigation of the validity of the order. This fundamental right was not afforded the company by the state supreme court.

Atchison, Topeka & Santa Fe Railway Co. v. United States, 284 U. S. 248, 262 (1932).

Ohio Valley Water Company v. Ben Avon Borough, 253 U. S. 287, 289 (1920).

Ohio Utilities Company v. Public Utilities Commission of Ohio, 267 U. S. 359, 364 (1925).

State Corporation Commission of Kansas v. Wichita Gas Co., 290 U. S. 561, 569 (1934).

Bluefield Company v. Public Service Commission, 262 U. S. 679, 689 (1923).

Prendergast v. New York Telephone Company, 262 U. S. 43, 50 (1923).

Lehigh Valley R. R. v. Commissioners, 278 U. S. 24, 36 (1928).

United Railways and Electric Company of Baltimore v. West, 280 U. S. 234, 251 (1930).

Crowell v. Benson, 285 U. S. 22, 60 (1932).

Van Wert Gaslight Co. v. Public Utilities Commission of Ohio, 299 Fed. 670, 676 (1924).

Chesapeake & Potomac Telephone Company of Baltimore v. West, 7 F. Supp. 214, 230 (1934).

ARGUMENT.

I.

A Review of the Record by this Court will Disclose that the Decision of the Commission and of the State Supreme Court Disregards Controlling Legal Principles.

The commission rate order is based upon the alleged fact that under existing rates the company would have made a return on the rate base of 9.52% per annum during the rate period, and that such a rate of return would be excessive. To support the premise, elaborate calculations are indulged in by the commission. The record abundantly proves that these are "at war with realities." As this court has recently had occasion to point out, the actual experience of a company is more convincing than tabulations of estimates.*

The company commenced its operations December 1, 1924, barely three years before the passage of the rate ordinance in question. In April, 1925, its rates were fixed by the commission. At the end of 1931 its book surplus account built up under existing rates was only $67,601.83. (R. 786). Among its assets were deferred charges of $57,798.33. (R. 785). Of these deferred charges $31,545.37 covered rate case expenses in connection with this rate case. (R. 542). The record does not show the nature of the other deferred charges. If one deducts from the book surplus merely the deferred rate charges in the Lima case, the surplus accumulated in more than seven years of operation is but $36,056.46. Common stock dividends paid were never in any year as much as 4%, and

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* NOTE: *Lindheimer v. Illinois Bell Telephone Co.*, 292 U. S. 151, 163-4 (1934).

during the first three years of the company's operations no dividends were paid on common stock. (R. 553-4). The commission refused to put in evidence the company's last annual report to it, which shows the fact that at the end of 1932 the corporate surplus was less than at the end of 1931, and that in 1932 no common stock dividends were paid. The situation has not improved since 1932. While the fact is not of record in these proceedings, it is a matter of public record that, as an outgrowth of this rate litigation, the company is involved in proceedings for reorganization under the recently enacted Sections 77A and 77B of the federal bankruptcy act. (*In the Matter of West Ohio Gas Company, Debtor*—In Proceedings for Reorganization No. 10893 in the District Court of the United States for the Northern District of Ohio, Western Division.)

In spite of these startling realities as to lack of adequate earnings by the company, the commission has ordered the company to lower its rates for the past five years to an extent that would require refunds to consumers in one community which will total more than $330,000.00, exclusive of interest. The foregoing facts alone indicate clearly not only that the commission order is unreasonable under the regulatory statute, but that under the order the property of the company would be confiscated for the public service. They also show that the commission action in fixing rates in this case has not been based upon the controlling legal principles which must be followed if the company is to be afforded due process of law as guaranteed by the constitution of the United States.

A study of the entire record impels one to the conclusion that the commission set about to fix a lowered rate in this case, regardless of its right under the law and the evidence so to do. As will be specifically pointed out, its action was arbitrary and wholly at variance with the evidence; and its findings are in numerous instances unsup-

ported by and contrary to the evidence, or are based on data not properly put in evidence, or are the result of errors in arithmetic. If the rate order be permitted to stand, the property of the company devoted to the public service will have been taken without adequate compensation. And the Supreme Court of Ohio has not made that independent review of the law and the facts which is essential if due process is to be afforded the company.

The commission, after revising its original order by a *nunc pro tunc* order entered without notice to the company, found that the company would have, under the rates fixed by the commission, an annual return of approximately 6.65%. (R. 118-22).

In order to reach this conclusion, it was necessary for the commission to disregard more than 21% of the actual expenses of operation; to assume that earnings for 1932 and the first four months of 1933 would be at a rate equivalent to the *average* for the preceding four years; and to proceed upon errors made by its accountants in calculating revenues and customer averages and in overlooking part of the expense accounts, which errors misled the commission by 1.2% as to the actual percentage of return that would be derived per year. When these clearly demonstrated errors of the accountants are corrected, and rate case expense is taken into account and spread over the ordinance period, the return earned by the company under the commission rates (even after eliminating for each annual period the more than $71,500.00 of operating expense that were excluded by the commission) would average less than 5½% for the first four years of the ordinance period, and but about 5¼% for the whole ordinance period. (See Appendix A, pp. 176-84, *infra*).

That the return, even on the commission's theory of the case, is in fact reduced to such percentages, is a mere

matter of mathematical calculations. This fact was not only demonstrated plainly to the state court, but the assistant attorney general, who was counsel for the commission when the case was briefed and first argued, admitted both the errors of the commission's accountants and the necessity of allowing rate case expense; and, in order to avoid needless discussion and confusion as to these errors, worked out with counsel for the company tables in which these errors were eliminated. These show the figures obtained by applying with mathematical correctness the theories expounded in the commission order. (See Appendix A, pp. 179A, 181A, 183A, *infra*). Determination for oneself of the accuracy of these tables requires only the time necessary to check the data set forth in the exhibits in the record. These corrected tables were submitted to the state court. They were discussed on the reargument of the case. The fallacy of a claim made at that time by the newly appointed assistant attorney general as to the amount of the item of "Cost of Gas Produced and Purchased" was abundantly exposed. (Appendix A, pp. 189-90, *infra.*) It seems incredible, but it is a fact that, even after these numerous errors of the commission in making its calculations had been so plainly pointed out to the state court and tabulated for it, that court handed down an opinion in which it upheld the commission's order, relied upon the discredited figures used by the commission, and insisted that the commission's rates would produce a 6% return for the rate period. The court's opinion discloses irrefutably that the court did not give consideration to the facts of the case, and paid no attention to the briefs that were filed except to cull out of the briefs for the commission such of the statements (many of which have been recognized as erroneous by their counsel) as, however incorrect, would serve to lend color to a decision that

the commission's order should be affirmed upon the ground that it gave the company a 6% annual return for the rate period.

We think this court should keep these factors in mind throughout its consideration of this case. We submit that it is self-evident that the state court has not given the company that independent review of the law and the facts which due process requires. In this situation we submit this court should either afford the company that independent judicial review of the facts and the law to which it is entitled or remand the case and direct the state court so to do.

We shall discuss the numerous errors in this case under the general headings which have been set forth under the "Specification of Assigned Errors Intended to Be Urged," pp. 29-33, *supra.*

II.

The State Supreme Court Erred in Not Holding that the Rate Order was Void because the Commission had Predicated the Order on Matters Not Properly in Evidence.

In order to build up the appearance that a large net return was being earned by the company from Lima service, the commission made heavy reductions in most of the items of operating costs actually incurred by the company. To give any color to many of these attempted eliminations, it was necessary for the commission to rely upon annual reports of the company that were not a part of the evidence in the case. These annual reports were documents that had been filed by the company with the commission under the requirements of the state law. The information contained therein was set forth in such form as the law and commission regulations required. After the hearings had ended, the commission arbitrarily put in

evidence these reports for the years 1928, 1929, 1930 and 1931, and refused the company an opportunity to be heard in reference to them.

Hearings in the rate case were closed on July 19, 1932. The rate order was not entered until March 10, 1933, almost eight months later. We do not, of course, know just when the idea of using the reports was conceived by the commission, but we do know that the first information that the company had on the subject was *after* it had been notified of the final rate order. The commission, after serving upon the company a copy of the rate order, served the company with a copy of an order, dated March 8, 1933 (two days earlier), which made the four annual reports a part of the record. (R. 85). The company promptly asked for a rehearing. This the commission denied. (R. 117).

We do not claim that certain of the data in the reports would not have been competent evidence if the commission desired to introduce it in the proper manner during the hearings. Likewise, we do not deny that the commission could have reopened the case at any time after July 19, 1932 and introduced such parts of the reports as were competent, if it had at such time afforded the company a reasonable opportunity to object to the incompetent parts, to explain the data therein, to show the proper deductions that could be drawn from the competent data intro uced, and to offer any additional evidence that it might then have deemed needed. Even if such opportunity had been given when suitably requested by petition for rehearing, the company would not now be urging error.

Nothing like that was done. Sometime during the eight months that elapsed between the termination of the hearings and the issuance of the rate order, the commission decided upon the scheme of reducing actual operating costs

by means of customer averages that it could develop from data in the annual reports. Its opinion shows that its decision as to its allowances for several important items of expense was predicated solely upon the use of such data. (R. 93). From its order dated March 8, 1933, putting the reports in the record, it is clear that the commission was aware that it could not lawfully rely upon them unless they were in evidence. Yet it did not notify the company of this additional evidence until after it had entered its final order and it then denied the company any opportunity to be heard in respect to that evidence.

Such a denial of the most fundamental rights of a litigant has never been countenanced by this court. Uniformly this court has set aside administrative orders predicated on such a disregard of rights. The decisions here are clear and harmonious. They hold that a failure to observe this basic requirement necessitates a reversal of the order upon the ground that due process has been denied.

In *United States v. Abilene & Southern Railway Company*, 265 U. S. 274 (1924), a case particularly significant here because of the action of the commission in reference to the annual reports of the company, this court, in holding a legislative order void because of failure to observe the principle heretofore discussed, said, pages 286-290:

> "The plaintiffs contend that the order is void because it rests upon evidence not legally before the Commission. It is conceded that the finding rests, in part, upon data taken from the annual reports filed with the Commission by the plaintiff carriers pursuant to law; that these reports were not formally put in evidence; that the parts containing the data relied upon were not put in evidence through excerpts; that attention was not otherwise specifically called to them; and that objection to the

use of the reports, under these circumstances, was seasonably made by the carriers and was insisted upon. * * *

"* * * a finding without evidence is beyond the power of the Commission. Papers in the Commission's files are not always evidence in a case. *New England Divisions Case,* 261 U. S. 184, 198, note 19. Nothing can be treated as evidence which is not introduced as such. *Interstate Commerce Commission v. Louisville & Nashville R. R. Co.,* 227 U. S. 88, 91, 93; *Chicago Junction Case,* 264 U. S. 258. * * *

"* * * The objection to the use of the data contained in the annual reports is not lack of authenticity or untrustworthiness. It is that the carriers were left without notice of the evidence with which they were, in fact, confronted, as later disclosed by the finding made. The requirement that in an adversary proceeding specific reference be made, is essential to the preservation of the substantial rights of the parties.

"* * * The matter improperly treated as evidence may have been an important factor in the conclusions reached by the Commission. The order must, therefore, be held void."

And in the case at bar it is clear from the opinion of the commission that the reports which were improperly treated as evidence not only might have been but in fact were the foundation for conclusions reached by the commission.

Interstate Commerce Commission v. Louisville and Nashville Railroad Company, 227 U. S. 88 (1913), involved a commission order revising certain rates. In the appeals to the courts, the direct issue was presented whether the commission could lawfully base its order on an asserted "opinion" not founded upon the evidence in the case. In the appeal here, this court held that the commission could not do so. It said, pages 91-4:

"In such case it (the government) insisted that the order based on such opinion is conclusive, and (though *Int. Com. Comm. v. Union Pacific R. R.*, 222 U. S. 541, 547, was to the contrary) could not be set aside, even if the finding was wholly without substantial evidence to support it.

"1. But the statute gave the right to a full hearing, and that conferred the privilege of introducing testimony, and at the same time imposed the duty of deciding in accordance with the facts proved. A finding without evidence is arbitrary and baseless. And if the Government's contention is correct, it would mean that the Commission had a power possessed by no other officer, administrative body, or tribunal under our Government. It would mean that where rights depended upon facts, the Commission could disregard all rules of evidence, and capriciously make findings by administrative fiat. Such authority, however beneficently exercised in one case, could be injuriously exerted in another; *is inconsistent with rational justice, and comes under the Constitution's condemnation* of all arbitrary exercise of power.

* * *

"The Government further insists that the Commerce Act (36 Stat. 743) requires the Commission to obtain information necessary to enable it to perform the duties and carry out the objects for which it was created, and having been given legislative power to make rates it can act, as could Congress, on such information, and therefore its findings must be presumed to have been supported by such information, even though not formally proved at the hearing. But such a construction would nullify the right to a hearing,—for manifestly there is no hearing when the party does not know what evidence is offered or considered and is not given an opportunity to test, explain, or refute. The information gathered under the provisions of section 12 may be used as basis for instituting prosecutions for

violations of the law, and for many other purposes, but is not available, as such, in cases where the party is entitled to a hearing. The Commission is an administrative body and, even where it acts in a quasi-judicial capacity, is not limited by the strict rules, as to the admissibility of evidence, which prevail in suits between private parties. *Int. Com. Comm. v. Baird,* 194 U. S. 25. *But the more liberal the practice in admitting testimony, the more imperative the obligation to preserve the essential rules of evidence by which rights are asserted or defended. In such cases the Commissioners cannot act upon their own information as could jurors in primitive days. All parties must be fully apprised of the evidence submitted or to be considered, and must be given opportunity to cross-examine witnesses, to inspect documents and to offer evidence in explanation or rebuttal. In no other way can a party maintain its rights or make its defense. In no other way can it test the sufficiency of the facts to support the finding; for otherwise, even though it appeared that the order was without evidence, the manifest deficiency could always be explained on the theory that the Commission had before it extraneous, unknown but presumptively sufficient information to support the finding. United States v. Baltimore & Ohio S. W. R. R.,* 226 U. S. 14."

In *The Chicago Junction Case,* 264 U. S. 258 (1924), the court said, pages 262-6:

> "Facts conceivably known to the Commission but not put in evidence will not support an order. *Interstate Commerce Commission v. Louisville & Nashville R. R. Co.,* 227 U. S. 88, 93. • • •
>
> "Upon application of a carrier, the Commission must form a judgment whether the acquisition proposed will be in the public interest. It may form this judgment only after hearing. *The provision for a hearing implies both the privilege of introducing evidence and the duty of deciding in accordance*

> *with it.* To refuse to consider evidence introduced or to make an essential finding without supporting evidence is arbitrary action. As it was admitted by the motion that the order was unsupported by evidence, and since such an order is void, there is no occasion to consider the other grounds of invalidity asserted by plaintiffs."

A hearing by the commission on appeals from rate ordinances is required under the Ohio law. (General Code of Ohio, section 614-44.)

In *Northern Pacific Railway Company v. Department of Public Works,* 268 U. S. 39 (1925), this court reiterated the principle in the following language, pages 44-5:

> "But where rates found by a regulatory body to be compensatory are attacked as being confiscatory, courts may enquire into the method by which its conclusion was reached. An order based upon a finding made without evidence, *The Chicago Junction Case,* 264 U. S. 258, 263, or upon a finding made upon evidence which clearly does not support it, *Interstate Commerce Commission v. Union Pacific R. R.,* 222 U. S. 541, 547, is an arbitrary act against which courts afford relief. The error under discussion was of this character. It was a denial of due process. Compare *New York & Queens Gas Co. v. McCall,* 245 U. S. 345, 348."

In *Washington ex rel. Oregon R. R. & N. Co. v. Fairchild,* 224 U. S. 510 (1912), this court said, pages 524-5:

> "• • • the hearing which must precede the taking of property is not a mere form. The carrier must have the right to secure and present evidence material to the issue under investigation. It must be given the opportunity by proof and argument to controvert the claim asserted against it before a tribunal *bound* not only to listen but to *give legal effect to what has been established.*"

And in *Crowell v. Benson*, 285 U. S. 22 (1932), this court recently reaffirmed its adherence to this principle. It there held, page 48:

> "Facts conceivably known to the deputy commissioner, but not put in evidence so as to permit scrutiny and contest, will not support a compensation order. *Interstate Commerce Commission v. Louisville & Nashville R. Co.*, 227 U. S. 88, 93; *The Chicago Junction Case*, 264 U. S. 258, 263; *United States v. Abilene & Southern Ry. Co.*, 265 U. S. 274, 288."

And commission findings as to valuation and operating expenses were held erroneous under this principle, in *Ohio Utilities Company v. Public Utilities Commission of Ohio*, 267 U. S. 359 (1925), a case coming up from the Supreme Court of Ohio.

All the foregoing decisions were called to the attention of the state court, and the excerpts above quoted set out in the briefs filed there. The state court wholly failed to give the company protection against this arbitrary action of the commission, or to pay any attention to the issue. Surely the rights of a litigant cannot be thus blindly cast aside. We are confident that this court will not show a like disregard for these fundamental rights. We respectfully submit that for the reasons just discussed, if for no other, the rate order is void, and that it must be set aside. We further submit that the state supreme court erred in not so holding, and that its judgment must be reversed.

III.

The State Supreme Court Erred in Affirming the Finding and Order of the Commission which fixed Rates upon the Basis of an Arbitrary Disregard of Operating Costs incurred by the Company in Rendering the Service.

The actual operating costs incurred by the company in rendering Lima service, as was proved by the evidence,

averaged $384,194.43 per year for the four-year period ending with 1931.

The commission's opinion stated that the expenses as taken into account by the commission averaged $301,920.92 per year for that period. In the appeal to the state supreme court it was admitted by counsel for the commission that this expense figure was erroneous because of errors in calculation and inadvertent omissions made by the commission's accountants in attempting to use figures they had culled from the annual reports of the company, pp. 25-7, *supra*. The largest error as to expense calculations was in the general and miscellaneous account where the commission (principally because its accountants had overlooked one entire subdivision of these accounts contained in the annual reports) used an average yearly figure of $33,713.00 only in its opinion, whereas the amount that it should have used on its theory of determining such item of expense was $45,025.00 per year, if rate case expense were taken into account on the basis of amortization over the ordinance period. (See Appendix A, pp. 179-84, *infra*.) Other admitted errors in calculation by these concealed experts of the commission affected the distribution expense and commercial expense accounts of the commission calculation. These corrections increase to $312,600.42 the figure which the commission obviously intended to use, if rate case expense is to be amortized over a five-year period.

Conversely, they decrease by about 56/100ths of 1% the annual return that would have been earned by the company under the commission rates. We shall discuss that feature later, pp. 128-35, *infra*, and show that, when errors in the commission's calculations of revenues under the rate order are also corrected, the annual return under the rates fixed is, even if the commission's theoretical operating expenses be adopted, 1.2% less than the 6.65% that the commission's opinion stated it would be. At this point we want to pre-

sent argument to support the position of the company that the various disallowances of expenses were arbitrarily made, and are not warranted under the evidence.

In order that the differences between the operating expenses claimed by the company and those taken into account under the corrected commission figures may be easily compared, we have set forth a table showing the average expenses incurred in Lima service as shown by Company Exhibit 104 (adjusted to the service within the city in the manner hereinbefore explained, pp. 13-4, *supra*), and the expenses taken into account by the commission, when errors of its accountants are corrected and rate case expense included. (See Appendix A, pp. 176-84, *infra*.)

Operating Expenses	*City of Lima Company Average 1928-1931, both inclusive.*	*City of Lima Commission Average 1928-1931, both inclusive.*	*Difference.*
Gas Produced and Purchased	$150,361.75	$146,574.92	$3,786.83—
Distribution Expenses	40,622.11	34,428.00	6,194.11—
Commercial Expenses..	20,804.25	19,719.00	1,085.25—
New Business Exp.....	12,110.20	5,000.00	7,110.20—
General and Misc. Exp.	47,557.80	45,025.00	2,532.80—
Indirect Charges to Constr.	(3,825.51)	(3,804.00)	21.51+
Retirement Allowance	52,539.40	24,518.00	28,021.40—
Amortization of Pipe Line	22,935.97	.....	22,935.97—
Real and Personal Prop. Taxes	22,767.32	22,797.25	29.93+
State of Ohio—Excise Tax	7,107.79	7,114.25	6.46+
Tax of Ohio Pub. Util. Com.	277.82	278.25	.43+

Federal Income Tax....	8,494.25	8,504.00	9.75+
Uncollectible Accounts	2,441.28	2,445.75	4.47+
	$384,194.43	$312,600.42	$71,594.01
			x5
Total difference on Five-Year Basis			$357,970.05

( ) denotes red figures.

It will be noted from an examination of this table that the principal differences during the four-year period are in the items of cost of gas purchased and produced, distribution expense, commercial expense, new business expense, general and miscellaneous expense, retirement allowance, and amortization of pipe line allowance. In addition to the foregoing items of expense, there is, commencing with the year 1932, a state excise tax item (approximately $4,200.00 for 1932), which the commission ignored entirely, but which does not enter into the four-year period tabulation.

We propose to discuss each of these principal items separately, and we believe that our analysis of the commission reductions therein will disclose the facts that in each case the reduction is arbitrary, illegal and unwarranted, and that any rate order predicated on such reductions, or any of them, results in the confiscation of the company's property in violation of the fourteenth amendment to the constitution of the United States.

The ignored items of expense are of two classes—first, those that represent actual out-of-pocket expenditures made during the period in the rendering of the service; and secondly, those for depreciation and amortization reserve which are partly actually expended for replacements and

partly carried in a reserve account to protect the integrity of the investment.

There is in this case no problem growing out of payments to affiliated companies. The only expenditures of such a nature were those made for certain engineering, secretarial, accounting, statistical and advertising services rendered, which were paid for at less than cost. (R. 382-5). The total of such expenditures averaged about $4,450.00 per year. The company, complying with the requirement announced by this court in *Smith v. Illinois Bell Telephone Company*, 282 U. S. 133 (1930), showed fully the fact that the company paid the affiliate for the services performed an amount less than the actual cost incurred by the affiliate in rendering the service. (R. 413-6, 424-5). No elimination or reduction of this item was made by the commission.

If rate case expense be taken into account and amortized over the ordinance period, the average amount of the class of expenditures first above mentioned, which the commission has disregarded throughout the four-year period, is about $20,500.00 annually. (For the period subsequent to 1931 the increased amount of state excise tax, which was about $4,200.00 for 1932, has also been ignored.) This disregard of actual costs increased the figure for net return on the rate base by about 1.1% per year for the first four years of the ordinance period. The reduction for 1932 would be substantially greater because of the increased excise tax.

If these costs are added to those taken into account by the commission, the average net earnings by the company for the four years, 1928 to 1931, both inclusive, is found to be but 4.36% per annum under the commission rates.

In the latter group the average amount disregarded is about $51,000.00 annually. This disregard of expense of

operation increased the figure for net return on the rate base by an additional percentage of more than 2.6% per year. When this additional amount is considered, average earnings for the four-year period are found to be less than 1.75% per annum under the commission rates.

As to the first mentioned type of expenditures particularly, the chief issue centers around the disregard by the commission and the state court of a basic, and long and clearly established, principle heretofore always followed in rate proceedings. This principle is that, when payments to affiliates are not involved, expenditures proved to have been actually made in rendering the service cannot be disregarded unless and until fraud or mismanagement or at least abuse of managerial discretion in making the expenditures is shown by competent evidence.

There is nothing unworkable or unfair in such a rule. It is manifestly a fair one, practical in its application, and consonant with justice. It has long been recognized as the proper guide to govern a company in preparing and presenting evidence in a rate controversy. It is abundantly supported by numerous decisions upon which this company was warranted in relying in making its showing as to the cost of rendering the service.

The commission in its rate order proceeded to reverse this long settled rule; and the state court upheld such action. In effect, the commission has said that, if the necessity of any operating expenditure is questioned, either in the hearings or afterwards, the commission can reduce the actual expenditure to any point it sees fit to choose regardless of the fact that there is no evidence establishing abuse of managerial discretion or mismanagement or fraud. We shall hereafter show that the action of the commission in the case at bar was, as to many items of disregarded expense, not even predicated upon any

suggested challenge of the expense made known during the hearings. The first intimation that the company had that the expenditures were questioned in any way came in the rate order itself. As to none of the eliminated expenses was there any proof of abuses of managerial discretion, mismanagement or fraud. As to none of them was there any evidentiary basis for the amount of reduction decided on by the commission. It must be apparent that, under such arbitrary kind of procedure, a company has no real protection at all and that by such procedure there can always be a confiscation of the property used in the public service. The company might just as well be given no hearing at all as to be bound by a decision which is predicated on alleged issues never asserted during the hearing, or on conclusions unsupported by proof or not premised on the established principles of law.

We call the court's attention to the clear condemnation of such practices which are set forth in its many decisions cited on pages 57-62 of this brief. Those decisions are equally applicable to the phase of this appeal now being discussed as they are to the point we were there discussing. We feel certain that this court will not fail to see that the order attacked in this case has its foundation upon a disregard of the imperative necessity of observing *"the obligation to preserve the essential rules of evidence by which rights are asserted or defended."** If non-observance of these essential rights by a commission be

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**Interstate Commerce Commission v. Louisville and Nashville Railroad Company*, 227 U. S. 88 (1913).

For discussions, by a widely known writer on government, of the paramount importance of adequately safeguarding against arbitrary action those who are subject to administrative regulation, see Laski *"Liberty in the Modern State,"* pages 38-41, and Laski *"A Grammar of Politics,"* pages 393-4.

upheld, then due process and the right of judicial determination of whether constitutional protection for property devoted to the public service has been infringed, have indeed atrophied to hollow mockery.

Neither in making this point nor in urging the preceding one, pages 55-62, *supra,* are we seeking to advance for the company any point of mere technicality. We are in fullest accord with that recent notable enunciation in this court of the principles governing the determination of whether due process has been afforded or denied:

> "The concept of due process is not technical. Form is disregarded if substantial rights are preserved. In whatsoever proceeding, whether it affect property or liberty or life, the Fourteenth Amendment commands the observance of that standard of common fairness, the failure to observe which would offend men's sense of the decencies and proprieties of civilized life. It is fundamental that there can be no due process without reasonable notice and a fair hearing. Though the usual and customary forms of procedure be disregarded, the hearing may nevertheless be fair, if it safeguards the defendant's substantial rights." (From dissenting opinion of Mr. Justice Roberts in *Snyder v. Massachusetts,* 291 U. S. 97, 127-8 (1934).)

But in the case at bar the action of the commission has been that of denying fundamental and essential rights, and of acting arbitrarily and without evidence.

Rate controversies are of necessity complex proceedings. The field of possible challenge is so broad that no amount of foresight could anticipate all the possible items that a commission might attempt to disallow under the claim of a "judgment informed off the record." Any attempt to make an extensive showing as to each item of outlay and its particular place and need in the operation

of the property would be prohibitive in cost and result in sheer economic waste. That such is the situation, makes it all the more essential, if due process is to be afforded, that the points of actual challenge be made known clearly and that the respective obligations of the parties in the presentation of proof be definitely preserved. Without that, it is not only impossible to secure fair and just protection but there must be a heavy and needless expense in preparing for and presenting evidence in every such controversy. In cases of this type the commissions have their staffs of technical advisers, and quite generally, as was true in the case at bar, municipalities are fully represented. It is certainly not imposing any hardship on, or denying adequate protection to, the public when the law requires, as it now does, that any challenge of actual operating costs or of managerial acts be made known and supported by proof.

Clear and undisputed authority establish, and show the rationale of, the principle that fraud, mismanagement or an abuse of discretion must be proved before actually incurred operating expenses can be ignored.

In *Interstate Commerce Commission v. Chicago Great Western Railway Company,* 209 U. S. 108 (1908) this court said, pages 119-20:

> "• • • The presumption of honest intent and right conduct attends the action of carriers as well as it does the action of other corporations or individuals in their transactions in life. • • • Those presumptions of good faith and integrity which have been recognized for ages as attending human action have not been overthrown by any legislation in respect to common carriers."

In his historic concurring opinion in *Missouri ex rel. Southwestern Bell Telephone Company v. Public Service*

Commission of Missouri, 262 U. S. 276, 290 (1923), Mr. Justice Brandeis, in discussing the use of prudent investment as the rate base, made the following observation, the basic reasons for which are, we submit, equally applicable to expenditures made in the conduct of the business by the persons entrusted with its operation:

> "The term 'prudent investment' is not used in a critical sense. There should not be excluded from the finding of the base, investments which, under ordinary circumstances, would be deemed reasonable. The term is applied for the purpose of excluding what might be found to be dishonest or obviously wasteful or imprudent expenditures. *Every investment may be assumed to have been made in the exercise of reasonable judgment, unless the contrary is shown.*"

In the *Southwestern Bell Telephone Company* case, this court, in dealing specifically with operating expenses, stated the rule clearly, pages 288-9:

> "There is nothing to indicate bad faith. So far as appears, plaintiff in error's board of directors has exercised a proper discretion about this matter requiring business judgment. It must never be forgotten that, while the state may regulate with a view to enforcing reasonable rates and charges, it is not the owner of the property of public utility companies, and is not clothed with the general power of management incident to ownership. The applicable general rule is well expressed in *States Public Utilities Commission ex rel. Springfield v. Springfield Gas & Electric Co.*, 291 Ill. 209, 234, 125 N. E. 891, 901:
>
> > " 'The commission is not the financial manager of the corporation, and it is not empowered to substitute its judgment for that of the directors of the corporation; nor can it

> ignore items charged by the utility as operating expenses, unless there is an abuse of discretion in that regard by the corporate officers.' "

In *Banton v. Belt Line Railway Corp.*, 268 U. S. 413, 421-2 (1925), the court said:

> "Broad as is its power to regulate, the state does not enjoy the freedom of an owner. Appellee's property is held in private ownership, and, subject to reasonable regulation in the public interest, the management and right to control the business policy of the company belong to its owners. *Northern Pacific Railway v. North Dakota, supra,* 595, 596, 35 S. Ct., 429; *Norfolk & Western Ry. v. West Virginia, supra,* 609, 35 S. Ct. 437; *Interstate Commerce Commission v. Chicago G. W. Ry.,* 209 U. S. 108, 118, 28 S. Ct. 493, 52 L. Ed. 705."

In *Atchison, Topeka & Santa Fe Railway Co. v. United States,* 284 U. S. 248 (1932), the court stated, page 262:

> "But the Commission, exercising a delegated regulatory authority, *which does not have the freedom of ownership,* operates in a field limited by constitutional rights * * *."

In *Brooklyn Borough Gas Co. v. Prendergast,* 16 F. (2d) 615 (1926), the statutory court pointed out, page 623:

> "Neither the defendants nor the court is charged with the management of the plaintiff; neither may, in the absence of a showing of mismanagement, inefficiency, or bad faith, substitute its business judgment for that of plaintiff's officers. After the fullest examination of the plaintiff's property, books, and method of management, and after testing the truth of plaintiff's witnesses by cross-examination, defendants presented no evidence of fraud, waste, or inefficiency in plaintiff's management. * * *

> "Defendants do not contend that the plaintiff did not actually incur every item of operating expense as claimed, nor do they suggest that the plaintiff bases its claim upon other than accurate books of account. They did not *prove* waste or inefficiency, and I see no reason for substituting the hypothetical judgment of the accounting witness for one of the defendants for the actual experience of the plaintiff in the operation of its business, and I am of the opinion that operating expenses should be allowed in the amount claimed and proved for the year 1923, of $1,020,039.39."

In *Citizens' Gas Co. of Hannibal v. Public Service Commission of Missouri,* 8 F. (2d) 632 (1925), the court states, page 634:

> "The commission is not the financial management of the corporation, and is not empowered to substitute its own judgment for that of the directors of the corporation. There is no evidence of an abuse of discretion by the corporate officers in the matter of expenses."

The principle is trenchantly discussed and applied in the report by the special master appointed by a statutory federal court in the rate proceedings reported in *New York & Richmond Gas Co. v. Prendergast,* 10 F. (2d) 167 (1925). It is a clear statement of the applicable legal principles. This report, which in its treatment of operating expenses was approved by the court, states those principles as follows, page 181:

> "The operating cost and taxes for the years ending December 31, 1922, December 31, 1923, and the nominal year ending November 30, 1924, were established by the plaintiff's witnesses and books of account and were not controverted by the defendants. The defendants however, claim that certain items should be eliminated from these operating expenses, which I will now consider:

"First. Salary paid to Mr. Davidson, the company's comptroller, it being urged by defendants that such services were of such questionable nature as not to inure to the benefit of the company's consumers; also that the company was not operated, in the opinion of the defendants, in the most economical manner in so far as relates to the size and number of the company's gas sets.

"These two objections involve substantially the same question, namely: Did the management conduct its affairs with proper discretion and sound business judgment? In the absence of evidence to that effect, I assume that the management conducted its affairs discretely and with the sound business judgment that the ordinarily prudent business man would exercise in the conduct of his own affairs.

"In *Consolidated Gas Co. v. Newton,* Judge Learned Hand said: 'As to the necessity of having 7 cars I will rule here, as elsewhere, in the absence of some evidence showing that they were unnecessary, or that the officers abused their powers • • • that their judgment must stand prima facie. As in analogous situations, given the discretion, its exercise must be shown to have been injudicious • • • as in other cases where the matter rests in their discretion, I think that a presumption exists that it is well exercised until the contrary is shown.' *Consolidated Gas v. Newton* (D. C.) 267 F. 255; *State Pub. Utilities v. Springfield Gas,* 291 Ill. 234, 125 N. E. 891; *Southwestern Bell Telephone Co. v. P. S. C. Missouri,* 262 U. S. 276, 43 S. Ct. 544, 67 L. Ed. 981, 31 A. L. R. 807. Therefore, under the evidence, I have not eliminated from the costs of operation the salary paid to Mr. Davidson, or any portion of the costs of operation which may be asserted by some to have been paid by virtue of operating the enterprise in an alleged uneconomical manner.

• • • •

"• • • *The men who are skilled in the operation of a gas company must be presumed to have*

done their best, conscientiously and effectively, until the contrary is shown by competent evidence. Items of actual outlay may not be eliminated by the court merely because one or both of the defendants wish to cut out something.''

In the case at bar there was no evidence showing the eliminated expenditures were improperly incurred, or ought not to have been made in the exercise of honest business judgment. Practically all of them were entirely unchallenged.

See also:

Chesapeake & Potomac Tel. Co. v. Manning, 186 U. S. 238, 248 (1902).

Public Utilities Commission v. Springfield Gas and Electric Co., 291 Ill. 209, 234 (1919).

People ex rel. D. & H. Co. v. Stevens; 197 N. Y. 1, 10 (1909).

Columbus Gas Light Company v. Public Service Commission of Indiana, 193 Ind. 399, 404 (1923).

Monroe Gaslight & Fuel Co. v. Michigan Public Utilities Commission, 11 F. (2d) 319, 325 (1926).

Denver Union Stock Yard Co. v. United States, 57 F. (2d) 735, 747-749 (1932).

Re Milwaukee Electric Railway & Light Co., P. U. R. 1931E 289, 296 (1931).

We recognize that the scope of the foregoing principle has recently been limited by decisions of this court, which hold it inapplicable where transactions with an affiliated company are involved. It is clear in such situations that the common control over both the parties to the transaction destroys the presumption which is one of the foundations

of the general rule that the managers have acted in a manner deemed by them to be for the best interest of a single party in which they had an interest. In other words the reason upon which the principle is grounded, does not exist when one management is charged with the duty of looking after the oftentimes conflicting interests of both parties to a single transaction.

Smith v. Illinois Bell Telephone Company, 282 U. S. 133, 151 (1930).

Western Distributing Co. v. Public Service Commission of Kansas, 285 U. S. 119 (1932).

Dayton Power & Light Co. v. Public Utilities Commission of Ohio, 292 U. S. 290 (1934).

Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio, 292 U. S. 398 (1934).

But the rule in case of inter-company transactions has its very foundation in the intimacy of the affiliated relationship, and we believe this court has been careful to make such fact clear.

Thus in the *Western Distributing Company* case this court said, pages 126-7:

> "• • • *in view of the relations of the parties* and the power implicit therein arbitrarily to fix and maintain costs as respects the distributing company which do not represent the true value of the service rendered, the state authority is entitled to a fair showing of the reasonableness of such costs, although this may involve a presentation of evidence which would not be required in the case of parties dealing at arm's length and in the general and open market, subject to the usual safeguards of bargaining and competition."

And in the *Dayton* case this court said, page 843:

> "• • • the burden of proof was on the buyer of the gas to show that in these transactions with the

> affiliated seller the price was no higher than would fairly be payable in a regulated business by a buyer unrelated to the seller and dealing at arm's length."

The state court, while admitting the general principle in the seventh syllabus of its opinion, tried to disregard its application by asserting in its next syllabus that "when the integrity of such entries is attacked then the public utility carries the burden of supporting its entries by the greater weight of the evidence." It then erroneously assumed that there had been any such attack, and that the greater weight of the evidence supported each elimination of expense items made by the commission.

The assumptions are wholly unfounded. There was in this case no attack upon the "integrity of the entries," or any of them. In the hearings there was no question whatsoever raised as to any of the items reduced by the commission except the retirement and amortization reserves, and the query in cross-examination and by a city witness, who was wholly without experience in utility management, as to whether the results of new business expenditures were commensurate with the amount of expenditures. (R. 339-44, 453). We shall discuss these phases of the case more fully later. There was not one word of evidence or any claim made that mismanagement or abuse of managerial discretion or fraud existed. In the situation shown by the record here, the issue which the state court attempted to create is clearly moot. The pronouncement of the eighth syllabus is foreign to any problem in the case.

We think it important, however, that it should not go unchallenged as an exposition of any rule of law. Obviously it is at variance with the principle uniformly set forth in the decisions just discussed. It is in effect also a direct reversal of the age-old rule of law that the burden of proving an issue rests on the party asserting it. It

would establish a presumption of fraud, if fraud were mentioned. It would create a presumption of mismanagement, if mismanagement were claimed. Clearly it is not the law.

We do not claim that a management may be profligate or that it can overreach the bounds of a reasonable business discretion. There is, of course, a duty of honesty and prudence in management. But any claim that the management has failed in these respects must be supported by proof. Neither claim nor proof are to be found in this case.

We recognize, too, that where any such charges are made and proof thereof submitted, the court would be called upon to determine how strong the showing of fraud or mismanagement or abuse of discretion must be before the regulatory body can disregard actual operating expenditures. That issue is not involved here. The inescapable fact here is, as a study of the evidence will disclose, that no such proof exists in the case at bar.

As to the items of unaccounted for gas loss expense, distribution expense, commercial expense and rate case expense, there was not even any suggestion, either by the city or by the commission, of any challenge as to the necessity for, or the reasonableness of the amount of, such expenditures. And as to the new business expense there was no evidence introduced to overcome the showing by the company as to these actual expenditures and the need therefor. The expenditures were simply disregarded in the commission order.

In its decision the state court entirely lost sight of this situation. It closed its eyes to the facts that the company had shown in full detail its actual expenditures for gas produced and purchased, distribution expense, commercial expense, new business expense, general and miscellaneous

expense and state excise tax expense in connection with Lima service; that there was no attack on the "integrity of the (se) entries;" and that in this situation the commission had ignored more than $82,000.00 of such actual expenses for the four years that it considered.

In spite of the profession by the state court and commission that they were not substituting their judgment for that of the operators, the thing done was a most flagrant and arbitrary usurpation of the domain of management. It is obvious that the commission merely decided to cut out whatever was necessary in order to have a pretext for reducing the rates; and that the state court blindly accepted that action.

A study of the record will show indisputably that, as to this first class of expenditures, there was, when the hearings closed, no evidence in the record under which disregard of any part of such operating costs would be warranted.

The company had made a full and complete showing as to its actual operating costs, and as to other factors affecting return. (R. 529-54, 316-426, which includes Company Exhibits 104, 105, 106 and 107). On items that were challenged, it showed specifically the need of the expenditures. Its chief accounting officer presented this exhibit and supplemented it by oral testimony. He was subjected to such cross-examination as both the city representatives and the commission desired to make.

The city expert and his associate were permitted free access to the books and records of the company and made a long and detailed study thereof. That study resulted in no challenge of the integrity, accuracy or clarity of the company's accounting records. The city expert, upon inquiry by his own counsel, stated that he had no difficulty in analyzing these accounting records and making his study of

expenses. (R. 433). This belies the commission's vague insinuation in its opinion in the *Kenton* case that the records were confusedly kept. (*Kenton* record 91). The city introduced in evidence the results of its examination of the company's books and presented its claims as to the operating costs and net return of the company. (R. 577-616, 426-87). That analysis checked closely with the information submitted by the company comptroller.

We call the court's attention to the analysis of the evidence as to operating cost which is set forth in the statement of facts, pp. 14-9, *supra*. We urge the court, if it has any doubt on this matter, to examine the exhibits and testimony as to these operating costs. That testimony will be found not to warrant or support the reductions in operating costs which the commission has attempted to make. The commission recognized this fact in its opinion. (See commission opinion, R. 93). It is further shown by the direct testimony of the city expert, Mr. Allensworth, who was the only person, other than company witnesses, who touched upon this subject: (R. 445-6).

> "Q. (By Mr. Light) You have not attempted a theoretical set-up of what the distribution expense, commercial expense, new business expense and general and miscellaneous expense items should be? A. No, sir, I have not.
>
> "Q. Why not? A. I do not believe that it would be entirely becoming of me to make such study. That is more in the nature of a study to be made by what is known in the profession as an industrial engineer or an efficiency expert. I do not attempt to qualify as such. • • •"

The commission introduced no evidence whatsoever upon the subject of operating costs. This cannot be charged to the lack of opportunity so to do. The initial

hearing on operating expenses and return was held June 7, 1932. The final order of the commission was not issued until March 10, 1933. Under the law the commission and its staff have access at all times to the accounting records of the company, and those records are always open to examination and investigation by the commission and its assistants. Furthermore, they are kept under the supervision of the commission and in accordance with rules promulgated by it.

The court not only will not find in the entire record any evidence of fraud, mismanagement or abuse of managerial discretion, but will not find any evidence establishing the unreasonableness of any of these expenditures. Surely, even if it were the law that the burden of proof as to the necessity for each expenditure rested on the utility, the company in this case could not be deemed to have failed to make the necessary showing when it detailed its actual outlays, and opened its entire records for an inspection and examination which was made by the opposition. Surely if any cause for disregard of such outlays exists, such showing must be overcome by evidence. Surely the regulatory body cannot sit by, and after the hearings have closed commence to create issues concerning which the utility has never been apprised, or make findings that are without support in the evidence in the record. If due process means anything at all, if it is to afford any protection at all, such arbitrary and high-handed procedure cannot be condoned.

We respectfully refer the court to the decisions heretofore cited and discussed, pp. 70-5, *supra*. Those decisions plainly show the unsoundness of the action of the commission and of the decision of the state court on this point. They set forth the true principles that must govern the correct determination of this case.

We desire now to point out the untenability of the action of the commission and the state court as applied specifically to each group of these operating expenses disregarded.

1. Gas Produced and Purchased.

The commission accomplishes this reduction of approximately $3,800.00 a year, or $19,000.00 for the five-year period, by arbitrarily reducing, by more than 22%, the unaccounted for gas losses of the company.

The commission opinion indicates that the method by which this reduction was made was solely that of ignoring the actual experience of the company as to losses through unaccounted for gas and arbitrarily fixing the allowance for such losses at 7% of the total gas manufactured. This was about 2% lower than the actual experience of the company.

The state court has assumed in its opinion that in the hearing before the commission there was an attack on "the integrity of the item" of unaccounted for gas. This assumption is in error. There is no testimony supporting the commission reduction. Although the company's operating data was subject to inspection and study by the city and commission staff, no challenge of any kind was made as to the reasonableness of the actual experience of the company as to this item of expense. There is not a single word in the evidence to warrant any claim that the unaccounted for gas losses were excessive; and there is not a word to support the statement of the commission that with "proper care" the loss could have been reduced to 7%.

The company showed its actual expenditures for gas, and its actual experience in unaccounted for gas losses. No question as to these losses was raised during the hearing by either the city or the commission. The first intima-

tion which the company had of any challenge of the item was the order itself. A petition for rehearing was denied. Certainly if the incurred expense is to be challenged, that challenge must be founded on evidence properly introduced during the hearings. The company must be informed of the issue, and be given an opportunity to meet any evidence that might be produced to support the claim.

The commission apparently attributed the entire unaccounted for gas losses to leakage. As a justification for the reduction, the commission on page 5 of its opinion, under a paragraph captioned "Gas Leakage," states that "this [the 9%], we believe to be excessive and with proper care of the system could be reduced to 7%, which we allow." The opinion gives no intimation as to what this "proper care" should be, or wherein the management is lacking in the exercise of "proper care." There is no evidence that these losses of the company were excessive, or that they could practically or economically be reduced below the 9%.

As a matter of fact, unaccounted for gas losses are not due entirely to leakages in mains or services. Many other factors contribute to them. To name the more obvious ones, there is the difference resulting from the reading of a single meter at the point of send-out and the readings of the thousands of meters on the premises of individual consumers, from the item of stolen gas (far from an insignificant item in the gas business, especially during the prohibition period), from differences in volume due to temperature of gas as measured, from shrinkage due to condensation in mains and holders, and from metering inaccuracies. The amount of such losses vary widely in different properties and at different times in the same property. To a considerable extent they are wholly unavoidable, regardless of expenditures made in attempted

prevention. The point at which it becomes economically advisable to spend additional moneys in maintenance and in investigations in an effort to diminish the amount of unaccounted for gas is one which is primarily a question of managerial judgment.* In the absence of a showing to the contrary, that judgment must be deemed to have been honestly and intelligently exercised. In this case there is not one word of evidence showing any claim of abuse or lack of wisdom in the exercise of that power of judgment.

Until and unless it is established by evidence that the loss has reached a point that is so out of line with general experience in the gas business that a case of abuse of managerial discretion is shown, or that there are available preventive measures that are practical and that sound management should have adopted, the commission cannot eliminate a part of the cost of gas because such losses exist.

In *Brooklyn Union Gas Co. v. Prendergast,* 7 F. (2d) 628 (1925), this very question was presented to a federal court.

In that case gas rates fixed by the state authority were being challenged as confiscatory. The attorney general,

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*NOTE: For interesting and instructive reports based on studies of unaccounted for gas losses, see the reports on unaccounted for gas by subcommittee of the Pacific Coast Gas Association:

14 Proceedings Pacific Gas Association 124 (1922), in which twenty-six factors responsible for unaccounted for gas are outlined.

14 Proceedings Pacific Gas Association 679 (1923).

15 Proceedings Pacific Gas Association 387 (1924), in which "actual losses" and "fictitious losses" are discussed.

defending the rates, sought to have the allowance for unaccounted for gas limited to 5%. The special master refused so to do, and allowed the amount shown to have been actually experienced. He said, page 652:

> "There is always an item of 'unaccounted for' gas. This is due to leakage, condensation, expansion, and contraction, among other things. An allowance must always be made for this item as a part of the cost of manufacture. What percentage shall be thus allowed has been the subject-matter of considerable dispute. This factor varies with the consumption per mile of main, with the number of consumers within a given distance, and with reference to other factors. It seems incapable of determination with precision, but experience enables these companies to determine approximately what this item ought to be. The Attorney General contends that 5 per cent. is an appropriate allowance. The records of the plaintiff indicate what this item amounts to in actual practice with them, and in the absence of any evidence attacking either the integrity of the record or tending to establish extravagance in that regard, I have accepted the company's own records as indicating the allowance that should be made for this item."

In approving this portion of the special master's report, the court stated, page 671:

> "The Attorney General contends that unaccounted for gas, that is due to leakage, condensation, expansion, and contraction, among other things should be allowed at an arbitrary figure of 5 per cent., but I do not agree with him, because in my opinion the proper method is to allow it on the basis of the companies' own records, which show the result of experience."

In the case at bar there is no evidentiary basis whatsoever even tending to support the commission act of allowing as an operating expense an amount less than the actual cost to the company of the gas that it has been necessary to produce or purchase in order to have sufficient gas to supply its customers. We need not here discuss how far the powers of the commission go in a case where mismanagement or incompetence are established. In this record there is a complete absence of any evidence showing any such situation or, in the language of the *Brooklyn Union Gas Co.* case, "attacking either the integrity of the record or tending to establish extravagance in that regard." The right of the company to have the full amount of such item taken into account was not even questioned in these proceedings. It is answer enough here that no legal support for this phase of the commission order can be found in the record.*

The court's assumption in its opinion (R. 31-2) that the percentage of loss of 9% is "so unreasonable on its face as to warrant investigation," is wholly out of line with the general experience of the gas distribution industry. It discloses a complete lack of understanding of the subject of unaccounted for gas.

The fact that send-out percentage comparisons blindly employed are productive only of meaningless results is well pointed out in the authorities to which we have heretofore referred the court in the note on page 84, *supra.*

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*NOTE: We suggest in passing, however, that an examination of the reported unaccounted for gas loss experience of gas companies generally, will indicate clearly that the experience of this company is not out of line with that of most gas distributing companies and is considerably better than the average. (See annual editions of *Brown's Directory of American Gas Companies.*)

In the 1922 committee report on unaccounted for gas losses contained in 14 *Proceedings Pacific Coast Gas Association* 124, the committee stated, page 125:

> "As has often been proven, the expression of unaccounted for gas as a percentage of the sales or send out is not a true basis for comparison. Neither is the expression of unaccounted for gas as the amount of annual loss per mile of main of a given size entirely satisfactory. Some channels through which gas is lost bear a direct percentage to the amount of gas sent out; others are in proportion to the miles of mains, while some are related to the number of services, pressures carried, the quality and kind of gas, the age and type of system and the character of the soil. Obviously, there is no short method by which a true unaccounted for gas coefficient may be obtained which will apply equally as well to all systems."

And in the report of the 1923 committee, these facts were further stressed and graphically illustrated. The committee report stated (14 *Proceedings Pacific Coast Gas Association*, 679, 682-3):

> "The following table will show how, by using the figure of unaccounted for gas expressed in percentage of send-out, one idea would be formed, while by using figures expressing the unaccounted for per mile of main on a six-inch basis or in percentage of sendout if the annual sales per consumer were taken at 50,000 cubic feet, other ideas would be formed, no two of which would agree.
>
> (See next page for table).

Gas Co.	*Position*	*Per Cent Unaccounted for*	*Per Mile of Main 6" Basis*	*Position*	*Sales per Consumer*	*Unaccounted for in per cent of Send-out on basis of annual sales per consumer of 50,000 cu. ft.*	*Position*
A	2	9.2	43,926	7	55,000	10. %	7
B	11	19.	.....	....	34,386	15.6 %	9
C	9	14.9	39,355	6	37,600	11.6 %	8
D	6	11.75	31,552	5	37,000	8.74%	3
E	10	18.10	4,564	1	21,643	8.7 %	2
F	7	13.80	28,164	3	30,011	8.9 %	5
G	4	10.61	56,523	8	41,800	9. %	6
H	3	9.60	28,984	4	41,920	8.2 %	1
I	5	10.90	21,965	2	39,343	8.8 %	4
J	8	14.4	121,975	10	125,611	30.8 %	11
K	1	6.8	61,602	9	198,853	24.2 %	10
L							

"Examination of the table will show that, while the unaccounted for gas of a company expressed in the ordinary way of percentage of sendout might be very low and tend to show the system in good condition, conversion of this figure into other terms might disclose the opposite."

Furthermore, if an arbitrary allowance by the commission for unaccounted for gas were permissible, it would be necessary to make an increased allowance in maintenance expenses for the work necessary in the endeavor to search out and eradicate the gas losses. The commission admits on page 5 of its opinion that in order to diminish the amount of unaccounted for gas, additional "care of the system would be necessary," but no allowance for such expense is made in the commission's estimate of operating costs.

We submit that the elimination by the commission of a part of the cost of gas is not based upon the evidence, and that the action of the commission in making this reduction in operating expenses is arbitrary and unwarranted, and cannot be sustained.

2. Distribution Expense.

The commission reduced the actual average distribution expense of the company by approximately $6,200.00 a year, or a total of $31,000.00 for the ordinance period. The state supreme court upheld this reduction. The reduction was made by finding the average distribution expense per customer during the period for all communities served by the company, and multiplying this by the average number of customers in Lima. In the table set forth in the commission's opinion the reduction in the actual distribution expense was but $5,729.36 (R. 120 and page 64, *supra*), but this figure was erroneous because of mistakes made by the commission's expert accountants in trying to figure the average number of customers in Lima each year. The corrected figure was substituted after the brief for the attorney general disclosed the method followed and the error made. (See Appendix A, pp. 183A, 170-1, 179-81).

The true distribution expense for Lima cannot be arrived at in the way attempted by the commission, and the adoption of such a scheme does not charge to the Lima service the real cost for such item incurred in rendering the service. The distribution expense in connection with gas service in Lima is directly charged on the books of that company to the Lima service. These costs are those incurred in connection with the local distribution of the product sold. They include the costs of superintending the distribution of gas, work on customers' premises in connection with rendering the service, changing of meters used to measure the gas sold, and the maintenance of the local distributing mains, services and meters. (R. 539). They are in no sense items of expense which are incurred jointly for all the communities served by the company. They are distinctly local expenses in each community served, attributable to the service in that community, and charged on the books of the company directly to that community. The undisputed evidence shows these facts. (R. 529-48, 318-9, 346-50).

In the main, the employees who render those services perform services in the Lima district alone. There can be no excuse for charging a part of these distinctly local services to other communities served by the same company, if rates are to be fixed for Lima alone. The company could be justly criticized if it did that on its books. There is no problem of allocation involved. Superintendence of the gas distribution system in Lima has no connection whatsoever with the superintendence of the local distribution systems in other communities. The expense of resetting a Lima customer's meter or of repairing a main or service in Lima does not in any way determine the cost of similar activities in the other communities; and there can be no justification for charging part of that expense to the con-

sumers in other communities, or, if the situation were reversed, for charging Lima consumers with a portion of these direct expenses incurred in other communities.

The commission's analysis of the company's entire operating expense, apparently disclosed that the distribution expense in the city of Lima ran somewhat higher per customer than it did in the other and smaller communities served. That this is true, is, of course, to be expected. In the larger city, there is more paving to be cut in making main repairs, wages are probably on a somewhat higher scale, and the percentage of customer change of residence is probably markedly higher. But the fact that it costs more to perform this service in Lima does not justify assigning a portion of this local expense to the cost of rendering service in Celina or Kenton or any of the other communities served by the company. Yet, that is exactly the effect of what the commission has attempted to do in this case. Such arbitrary cutting down of direct expenses is wholly without warrant; and we can well surmise the reaction both in the commission and in the other local communities, if the company endeavored to boost its actual distribution expense there incurred by the methods here pursued by the commission in order to cut down the real expense in Lima.*

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*NOTE: It is interesting to observe that in reaching its decision in the companion rate case of the company involving gas rates in Kenton (cause numbered 213 in this court) the commission abandoned its "customer average" methods of allocation applied in the case at bar. To have applied the "customer average" in that case would have increased distribution expense there by $3,315.39 for the single year considered by the commission. (See brief in cause No. 213, pp. 41-2). Of course, any allocation method used must be applied throughout the entire property.

This court has recently had occasion to point out that in fixing utility rates for a single community, a regulatory commission can ground its decision upon the earnings from that service without regard to what the earnings of the utility as a whole may be. *Wabash Valley Electric Co. v. Young,* 287 U. S. 488 (1933). It is a necessary corollary to that right that the commission has an obligation to determine fairly the expense of serving that community. In finding the amount of such expense the commission cannot proceed in a manner "unrelated to realities." To reach an incorrect but desired figure as to net earnings recourse may not be had to an arbitrary formula. *Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio,* 292 U. S. 398 (1934). *A fortiori,* allocations may not be made where the established facts are that the operating costs being considered are direct costs incurred exclusively for the single community whose rates are in issue.

This fundamental has been expressly pointed out by this court in past decisions dealing with analagous problems.

In *Northern Pacific Railway Company v. North Dakota,* 236 U. S. 585 (1915), this court, in discussing expense allocation said, page 597:

> "The outlays that exclusively pertain to a given class of traffic *must be assigned* to that class, * * *."

And in *Banton v. Belt Line Railway Corp.,* 268 U. S. 413 (1925), this court in discussing the method of determining the cost of carrying a given class of traffic stated, page 421:

> "And such cost includes *not only* the *expenditures,* if any, *incurred exclusively for that traffic,* but also a just proportion of the expense incurred for all traffic of which that in question forms a part."

Northern Pacific Railway Company v. Department of Public Works, 268 U. S. 39 (1925), likewise expressly holds that expense computations that are not founded on, but ignore the proof of, actual specific costs, will invalidate a rate order.

In that case the issue before the commission had been the fixing of rates for intrastate transportation of logs in the state of Washington. After hearing, the state commission ordered substantial reductions in rates. The carriers appealed to the courts, asserting that the findings of the commission were arbitrary and unsupported by the evidence, and that the rates fixed were confiscatory. The state supreme court upheld the commission decision, but the order was set aside by this court. This court discussed at length the nature of the error in the commission's action. Much of its criticism can with like force be applied to the action of the commission in the case at bar, and the like error made by this commission, in dealing with the evidence before it, vitiates its ruling. We, therefore, quote at considerable length. It was said, pages 42-4:

> "The three principal carriers presented evidence tending to show that their existing rates were so low as not to yield any return upon the property employed in the business; and that the rates did not defray fully the operating costs of the traffic and its proportion of the taxes payable. This evidence was in character persuasive. It was fairly specific, direct, and comprehensive. *If the facts warranted,* the *shippers and the public officials might,* of course, *have shown by evidence* of similar character *that the carriers' evidence was inherently untrustworthy; or it might have been overcome by more persuasive evidence to the contrary.* Little attempt was made to show that any testimony introduced by the carriers was inherently untrustworthy. Little conflict with the evidence of the carriers was de-

veloped by the evidence as to specific facts introduced for the shippers and the public. Apparently necessary inferences from specific facts established by the carriers were not explained away. The Department's findings concerning operating costs rested largely upon deductions from data found in published reports of the carriers and in their exhibits filed in this case. Instead of attempting to show by evidence, reasonably specific and direct, what the actual operating cost of this traffic was to the several carriers, the Department created a composite figure representing the weighted average operating cost per 1,000 gross ton miles of all revenue freight carried on the four systems and made that figure a basis for estimating the operating cost of the log traffic in Washington. This was clearly erroneous.

"A precise issue was the cost on each railroad of transporting logs in carload lots in western Washington, the average haul on each system being not more than 32 miles. In using the above composite figure in the determination of this issue the Department necessarily ignored, in the first place, the differences in the average unit cost on the several systems; and then the differences on each in the cost incident to the different classes of traffic and articles of merchandise, and to the widely varying conditions under which the transportation is conducted. In this unit cost figure no account is taken of the differences in unit cost dependent, among other things, upon differences in the length of haul; in the character of the commodity; in the configuration of the country; in the density of the traffic; in the daily loaded car movement; in the extent of the empty car movement; in the nature of the equipment employed; in the extent to which the equipment is used; in the expenditures required for its maintenance. Main line and branch line freight, interstate and intrastate, car load and less than car load, are counted alike. The Department's error

> was fundamental in its nature. The use of this factor in computing the operating costs of the log traffic vitiated the whole process of reasoning by which the Department reached its conclusion."

See also:

The Minnesota Rate Cases, 230 U. S. 352, 437 (1913).

The record in this case shows the actual distribution expenses incurred for Lima. They are direct costs attributable to that service, (R. 539), *and that service only.* In fixing rates, those costs and not some hypothetical ones, must be considered. The commission cannot substitute for actual cost of operation, its own theoretical estimates.

This was expressly pointed out in *Wisconsin-Minnesota Light & Power Company v. Railroad Commission of Wisconsin,* 183 Wis. 104 (1924). In that case, the court found that the company was entitled to net earnings of $39,002.50 in order to secure an 8% return. Its actual net earnings were $24,073.10; yet the commission had attempted to reduce the rates. The court, in setting aside the commission order, stated, pages 105-6:

> "The Commission arrived at its conclusion by substituting for the experience of the company estimates as to future revenues and future operating costs. In setting aside the existing rate the Commission cannot substitute for the experience of the company its estimates as to future revenues and operating costs. The net earnings of the company for the year ending October 31, 1921, was a completed operation. Estimates as to revenues could not change the fact as it existed. If it be assumed that the Commission, where there is evidence to show that an existing rate is unlawful, is justified in basing the substituted rate upon estimates, we cannot see how estimates can be used to establish the

> unlawfulness or unreasonableness of an existing rate. There is no attempt to sustain the order of the Commission in the case on any other basis than that of estimates. There is no claim that the management is willfully extravagant or that plaintiff improperly administers its property."

The principle is applicable with even greater force to a situation such as the case at bar where the commission is fixing rates applicable to a period that is already past.

3. Commercial Expense.

The actual commercial expense for the company for the Lima district as shown by the books of the company was reduced by the commission $1,085.25 a year, or more than $5,400.00 for the five-year period. The commission opinion shows a somewhat lesser reduction, due to the mistakes of its accountants in determining customer averages. The above figure is the one worked out with counsel for the commission as the reduction resulting after the commission method was properly applied. This method of reduction was accomplished in the same manner as the reduction for distribution expense (R. 93), and for the same reasons heretofore given, the commission method cannot be sustained.

The commercial expenses for Lima, shown in the company's accounts and set forth on pages 540 and 543 of the printed record, are almost entirely local expenses incurred in the Lima service and are direct charges to that service. These expenses include the cost of reading the meters, keeping the customers' accounts, and sending out and collecting bills. There is no place in these charges for the use of company averages, even if properly arrived at, and the reduction made by the commission in this item of expense must be corrected.

4. New Business Expense.

The heading "New Business Expense" is that used by the classification of accounts prescribed by the commission for the account in which are recorded expenditures made both for the purpose of securing new business and in the endeavor to retain against competitive services, business already had. The account designation is therefore something of a misnomer. (R. 339-44).

In dealing with this item of expense, the commission first applied its "averaging principle" and found, under its erroneous method of determining the average, that the average new business expense for the entire company for the period was $1.05 per customer. (Commission opinion, page 4. R. 93). The average number of customers in Lima during the period was 9,962. (See Appendix A, page 181, *infra*). Multiplying the $1.05 by 9,962 would have given the sum of $10,460.10 for an average year, or $1,650.10 less than the average actual expense annually incurred for this purpose by the company during the period. (See p. 64, *supra*). This would have resulted in an arbitrary reduction in this item of about $8,250.00 for the five-year ordinance period.

The result would have been incorrect and untenable for the same reason heretofore pointed out in discussing the treatment of distribution and commercial expenses by the commission. New business expense is a direct expense incurred in varying amounts in the different communities served. The amount expended is dependent upon the character of the community, the financial situation of its people, the probabilities of developing new uses of the product sold, and the press of competitive services. The charge is made directly to the community where the effort has been made, and is, of course, rightly a part of the cost of service in that community alone.

The commission did not, however, even give the company the benefit of the system average in this case. After establishing the average, it ignored the figure and arbitrarily limited the items of expense for new business to $5,000.00 a year. It thereby reduced this item more than $7,000.00 a year below actual expenditures, or by a total in excess of $35,000.00 for the ordinance period. The only justification offered for this disregard of an actual expenditure is that the commission is "not convinced • • • that the expenditures • • • should be allowed • • • in the full amount that they may have been spent" and that the allowance made is "in what we deem an ample sum." (R. 95-6).

Nothing more than these bald conclusions is offered as an excuse for or in support of the reductions. The action of the commission on this item of expense is in flagrant disregard of the rights of the company. It is wholly without support in the evidence in this case. Nothing can be there found upon which to predicate an arbitrary reduction by 60%, or in any amount whatsoever, of this very necessary expense. In fact the city in its exhibit as to operating expenses showed the item in full, p. 17, *supra*. (R. 582-6). The reduction therein made by the commission is no less arbitrary than those condemned by this court in *Ohio Utilities Company v. Public Utilities Commission of Ohio*, 267 U. S. 359 (1925).

The commission action is an unprecedented and inexcusable attempt by a commission to dictate the policies of management. It disregards the fundamental rights of management. If a commission can upon such flimsy pretexts disallow such expenses that have been made in good faith by a competent and experienced management, which bears the burden of operating and developing the property, of rendering adequate service, and of protecting the invest-

ments that have been made in the business, then there is nothing whatsoever left to the doctrine of private management, and there can be no security in utility investment. Fortunately the law does not countenance what the commission has here attempted. Like practices have repeatedly been condemned by the courts, and have been the foundation of reversals of commission orders.

In *Consolidated Gas Co. v. Newton,* 267 Fed. 231 (1920), the court was called upon to pass upon a challenge of new business expenses, in a case where rates had been ordered reduced by the state commission through the device of disregarding actual operating costs. In holding that the expenditures for new business made must be allowed, Judge Learned Hand said, page 253:

> "Their propriety is challenged largely because the sales have not increased much. The truth appears to be that the constantly increasing use of electricity for illumination has driven out gas more and more, until to hold its sales the plaintiff must promote the use of gas for heating and cooking. It has succeeded in a slight increase of sales, and its officers attribute their ability to do even so well to these departments. I have no doubt that they are right; but, whether right or wrong, their decision is not now open to question. They were under a duty to keep up their sales so far as they could, and to push the use of gas in any new ways which the public would use it. Even under municipal management, advertisement, when not pushed to the useless extreme which competition too often engenders, is a necessary function. In its proper sense it means, not the creation of a factitious demand by the familiar processes of repeated suggestion, but genuine information in such form as to reach the public."

In *Brooklyn Borough Gas Co. v. Prendergast,* 16 F. (2d) 615 (1926), the court, in overruling objections to items of actual operating expense, said, page 623:

> "Neither the defendants nor the court is charged with the management of the plaintiff; neither may, in the absence of a showing of mismanagement, inefficiency, or bad faith, substitute its business judgment for that of plaintiff's officers. After the fullest examination of the plaintiff's property, books, and method of management, and after testing the truth of plaintiff's witnesses by cross-examination, defendants presented no evidence of fraud, waste, or inefficiency in plaintiff's management. * * *
>
> "Defendants do not contend that the plaintiff did not actually incur every item of operating expense as claimed, nor do they suggest that the plaintiff bases its claim upon other than accurate books of account. They did not prove waste or inefficiency, and I see no reason for substituting the hypothetical judgment of the accounting witness for one of the defendants for the actual experience of the plaintiff in the operation of its business, and I am of the opinion that operating expenses should be allowed in the amount claimed and proved for the year 1923, of $1,020,039.39."

In *Monroe Gaslight & Fuel Co. v. Michigan Public Utilities Commission,* 11 F. (2d) 319 (1926), the court said, page 325:

> "* * * we see no reason why the discretion of the utility managers should have been revised. It is to be remembered, as has often been said, that the commission is to regulate rates but not to manage the business. The extent to which the utility managers should advertise and make efforts to get new business, or keep what they have, * * * are matters peculiarly of business management. * * * As to all disbursements actually made

> within the limits of good faith, the managers' discretion must stand, unless it is abused."

In *Citizens' Gas Co. of Hannibal v. Public Service Commission of Missouri,* 8 F. (2d) 632, 634 (1925), the court states:

> "The commission is not the financial management of the corporation, and is not empowered to substitute its own judgment for that of the directors of the corporation. There is no evidence of an abuse of discretion by the corporate officers in the matter of expenses."

And we call the court's attention again to the incisive language of the special master in the gas rate case reported in *New York & Richmond Gas Co. v. Prendergast,* 10 F. (2d) 167, 181 (1925), which so forcefully states the governing principles that the commission and state court have in this case been so ready to overlook:

> "* * * *The men who are skilled in the operation of a gas company must be presumed to have done their best, conscientiously and effectively, until the contrary is shown by competent evidence. Items of actual outlay may not be eliminated by the court merely because one or both of the defendants wish to cut out something.*"

We have already cited to the court additional decisions to the same effect, pp. 70-5, *supra.* This principle prohibiting infringement on the prerogative of management is not a mere platitude to be asserted and then disregarded. It is a vital principle, essential to the security of utility service as well as to the security of investments in utility property. No commission has the authority to disregard the fact, which is so succinctly stated by this court in *United Railways and Electric Company of Balti-*

more v. West, 280 U. S. 234 (1930), that in utility regulation "the fundamental principle to be observed is that the property of a public utility, although devoted to the public service and impressed with a public interest, is still private property; * * *." The burden and responsibility of managing a utility rests on those to whom the owners of the business have intrusted it, and it is not the function nor the duty nor within the right of the commission to interfere with the problems of operation until and unless mismanagement or abuse of discretion is shown to exist. In the present case there is not the slightest showing that either of those conditions existed. On the contrary, the evidence shows the management to be in the hands of competent men of long experience in the utility field.

The state court opinion asserts (R. 28) that: "The commission found *from the testimony* that the new business obtained by the gas company in Lima did not warrant the expenditure of $12,000 per year for new business —nor the half of it." No reference is made to indicate where any such testimony exists. The fact is that there is no basis for the assertion. Certain inquiries made by the commission and by counsel for the city of a company executive were along the line of suggesting that the results of the new business expenditures might raise a query as to the wisdom of making them. (R. 339-44, 453). But certainly the facts thus developed were not such as, by the wildest stretch of the imagination, could be deemed to have proved even any abuse of managerial discretion in these expenditures. On the contrary, that testimony served to establish more plainly the necessity for the outlay and the wisdom of the management in making it. Aside from the testimony given by the company, there was no evidence on the subject except the expense exhibit by the city taking the item fully into account and the following testimony by city witness Allensworth (R. 453):

"Q. Do I understand that in your opinion that new business expense is a proper charge? A. No, sir, I don't know that it is a proper charge, that is in amount. I have no criticism as to the entries made, but as to whether or not that is a proper amount, I would not say that it is.

"Q. Can you tell the Commission whether or not that expense is justified by increase in business, assuming that that department is entirely responsible for all increase that they may have? A. I do not think it is.

"CHAIRMAN HOPPLE: Your criticism goes to the fact that the amount spent is in excess of the results obtained?

"THE WITNESS: It so appears, yes, from the testimony of the company's witness."

We submit that there is nothing in any of the foregoing evidence that could be fairly relied upon as a justification for the commission's action in discarding approximately 60% of the actual expenses of the company for new business. Surely it cannot be said in the light of that evidence that there was any such showing as is necessary under the law if the judgment of a management is to be cast aside.

We refer the court to the following portions of the record, which we believe cover the complete testimony as to this item of expense: Record 339-44, 368, 373, 389, 416-8, 424, 453, 540, 543, 577, 582-9, 607-10; including Company Exhibit 104, pages 11 and 15; City Exhibit A-2, prepared by the company comptroller at the request of counsel for the city; and City Exhibit A-3, pp. 14-25. If the court has any doubt as to the necessity of allowing this item of expense in full, we ask it to read this testimony.

The state court's main attempt to justify its action in upholding the commission in eliminating more than $7,000.00 per year of the company's expenditures for new business was based upon the ground that there is no show-

ing in the record that the company had competition in its business. On this basis it made a feeble endeavor to distinguish existing authority. (R. 28). The conclusion of the court is unwarranted. The record shows plainly the necessity of the company making strenuous effort to preserve and increase its business. As the company comptroller trenchantly expressed the fact, "We have got to fight to keep what we have got and daily try to increase our gas sales to our customers." In the period here involved, industrial sales were increased from 9,941,200 cubic feet in 1927 to 32,320,000 cubic feet in 1931, and house heating increased from 2,698,800 cubic feet in 1927 to 12,489,200 cubic feet and 10,409,000 cubic feet in 1930 and 1931, respectively. (R. 577).

A review of the portions of the record above referred to will show the inaccuracy of the state court's assertion that there is no evidence of competition. Not only is competition shown by that evidence, but it is such a commonly known fact that such products as coal oil, coal and electricity as well as gas are used for domestic cooking, that such products as oil and coal as well as gas are used for house heating, and that such products as coal, oil and electricity as well as gas are used in industrial heating processes, that we submit that, if competition were an essential to the allowance of the expense and there had been no direct evidence of it, the court would be bound to take judicial notice of the fact that any gas company operates in a highly competitive field.

There is no basis whatsoever in the record to justify eliminating from operating costs, in fixing a rate, nearly 60% of these *bona fide* expenditures just discussed. It is plain that there is nothing in the evidence upon which to predicate any finding, or even suggest, that the managers of the company did not act "within the limits of good

faith'' or that managerial discretion was abused. We submit that the action of the commission and state court as to this item of expense was erroneous, and must be set aside.

5. General and Miscellaneous Expense.

There is much confusion in the labored explanation which the state court gives in endeavoring to support the general and miscellaneous expense item taken into account by the commission. In its opinion (R. 26), that court asserts that the commission allowed for general and miscellaneous expense the sum of $44,713.00 and then summarizes the objections of the company to this limited allowance. No such figure as $44,713.00 appears in the commission opinion nor was any such figure arrived at after taking into account the corrections and figures that counsel for the commission admitted should be made. The figure does however approximate the corrected figure for this item after rate case expense has been added thereto and spread over the five-year period covered by the rate ordinance. Such figure was $45,025.00 a year as shown in ''Appendix A'' hereto, pp. 181A, 182, *infra*. We at first thought that the last mentioned figure was the amount the court was referring to.

However, the discussion of the state court immediately following the figure shows clearly that the corrected figure was not the one considered, and the conclusion seems inescapable that, instead of the figure of $44,713.00,* the court intended to use the figure of $33,713.00, which is the figure for this item appearing in the commission's opinion. (R.

* Note: A like error was made by counsel for the commission in their purported statement of facts in their original brief. In copying that statement of facts the state court included the erroneous figure. (R. 22).

26). This conclusion is further supported by the fact that on page 316 of the court's opinion it sets out a table of average expenses per customer, which is the table originally relied on by the commission and which was clearly in error because of the miscalculations and omissions by the commission's expert accountants. (Appendix A, pp. 165-90, *infra*). Furthermore it is only by use of the $33,713.00 figure for general and miscellaneous expense that one can find any basis for the court's later statement that, if the operating expenses ignored by the commission were left out of account, the commission rates would produce a return in the neighborhood of 6% per annum for the years 1928 to 1931, both inclusive.

It is amazing that the court should have used these original figures after they had been admitted by everyone to be unreliable. It is even more amazing that the court should say (R. 26), in reference to general and miscellaneous expense, that "The alleged errors in calculation were treated fairly by the Commission," when even counsel for the commission had admitted in their briefs, and an analysis of the figures in evidence made it plain, that that portion of the general and miscellaneous expense that was included under general heading "H" in the annual reports, and which amounted to $9,784.28 for 1928, $10,357.76 for 1929, and $11,767.88 for 1930 (R. 669, 716, 762), had been missed by the commission accountants in developing their averages; when counsel had admitted in the agreed tables that the customer averages developed from the annual reports by those experts, was subject to revision (a fact that the figures in the record again indisputably establish); and when counsel had agreed, as the undisputed figures inescapably prove, that, even before the rate case expense was added, the average general and miscellaneous expense on the commission theory should with

correct figuring have been $39,235.00 instead of $33,713.00 per year. Upon adding the rate case expense, the general and miscellaneous item becomes $45,025.00 instead of the $33,713.00 per year. (See Appendix A, pp. 181A, 182, *infra*).

When the state court assumes even after these admissions to use the original figure named by the commission it becomes obvious that it has paid no attention to the briefs, the record or the oral argument, and has not had any comprehension of the corrections that it was recognized by everyone else had to be made. No stronger reason for the necessity in any event of sending this case back to the commission for corrected calculations could possibly exist than the confusion and the lack of understanding that the state court has shown in its attempt to deal with the blunders in mathematics made by the commission staff.

We do not believe it necessary to extend this argument by repeating here the analysis of the errors in the commission's calculations. In view of the confused treatment by the state court of this item of expense, we do respectfully urge this court to study that analysis as set forth in "Appendix A" 166-9, 171-7, 179-84, *infra*. Certainly, in fairness to the company, before this case is finally disposed of, either the reviewing court or the commission must make that study, must check the necessary corrections in figuring, and must take into account the full effect of making such corrections.

Such analysis will show that if the rate expense be spread over the five-year period the commission should have taken into account an average of $45,025.00 a year for general and miscellaneous expense even on its own theory of "customer averages." This is $2,532.80 less than the amount actually expended by the company for general and miscellaneous expense, the difference being

due to the "customer average" method of allocation which the commission adopted.

We submit that there is no justification for, and that there is reversible error in, the commission ignoring the company's method of allocation. The method is not only the one that the company has followed in keeping its accounts but is the accurate and correct one. It is a method that harmonizes with the nature of the expense item, whereas the commission method is wholly out of line with reality.

General and miscellaneous expenses are incurred principally for the company as a whole. Under this account are included the expenses of administration and other costs that have to do with the general management of the company. (R. 541, 545-8). Certain of the items are, however, incurred directly in connection with service in some particular community, and these are charged direct as a part of the cost of that service. Included among these direct costs are expenses in connection with rate controversies. (R. 544, 542). The other or joint expenses are first charged to a joint account and then allocated by the company monthly to each operating district upon the basis of the ratio between the gross revenue from gas sales in such district and the total gross revenue of the company from its gas sales. (R. 545-8). This method of apportionment was fully shown in the hearings before the commission and was in no way questioned in the proceedings. (R. 344-7, 349-50, 353-4). In fact it was adopted by the expert witness for the city who was in charge of the examination of the company's books. (R. 610-14, 453-5). It is obviously the most equitable basis of allocation in view of the nature of such expenses, which are somewhat analogous to overhead items in construction costs, and which within broad limits are but slightly, if at all, affected by the number of customers served. Certainly if the judgment of the man-

agement in this respect was to be attacked, the company was entitled to have this done by competent evidence introduced in the hearings.

There is no basis for the method of allocation used by the commission except it be found through a blind use of data in the annual reports of the company which were put in evidence by the commission after the hearings ended. As we have heretofore pointed out, the report calls for a consolidated figure for each item of expense, *i. e.*—the expenses in each community served are lumped into a single figure. The commission's method of treating these general expenses is plainly erroneous because under it general expenses incurred directly for one community are allocated between that community and other communities. This is improper as has been heretofore shown, pp. 90-6, *supra.*

The method is also unsound because it bears no rational relationship to the nature and character of the expense. Illustration of this is given by the fact that the method necessarily charges to a community the same amount of general and miscellaneous expense for the customer using 400 cubic feet of gas a month as it does for the customer using 100,000 cubic feet a month. No sound method of accounting would distribute general and miscellaneous expenses in such a way.

We submit that the commission erred in attempting to disallow the actual expenditures of the company for general and miscellaneous expense incurred in Lima service, and that the failure to include all such expense necessitates the reversal of the rate order.

We turn now to a discussion of that portion of the general and miscellaneous expense that was for rate case expense.

Counsel for the commission recognized that rate case expense should have been allowed. In their original brief

in the state court they thus explained the omission (Appendix A, p. 174, *infra*):

> "The commission was of course under the impression in taking annual report figures of the company that all its operating expenses incurred as of each year appeared therein."

They then continued (p. 174, *infra*):

> "We concur with counsel for the company that a reasonable rate case expense should be included * * *. There is no question here but that the company is entitled to a reasonable rate case expense as an operating expense inasmuch as the commission expressly found that the rates fixed in the ordinance appealed from were unjust and unreasonable (see Commission Order)."

Counsel suggested in their discussion, however, that the commission need only allow a reasonable amount for rate case expenditures and also suggested that the rate case expenditures in this case be spread over a six-year period "averaging $5,100 per year" (pp. 174-6, *infra*). This idea was based upon the claim that no new rate ordinance had been passed in Lima. The fact of the matter was that at the time counsel wrote the brief a new rate ordinance was pending before the council and was passed about the time the brief was filed. It was because of this fact that in the tables correcting the errors of the commission's accountants the then counsel for the commission consented that the rate case expense should be included in general and miscellaneous expense on a *five-year* amortization basis.

We have no quarrel with the claim that the commission is not bound to allow unreasonable expenditures in rate cases. Nevertheless the commission must determine the issue by the evidence and in the absence of any evidence

showing that the expenditures have been in an unreasonable amount the commission would not be warranted in arbitrarily ignoring the expense or any part thereof.

In the case at bar there was no claim advanced that the expenditures were improper or excessive. The company showed in detail the nature of the amount of its expenditures in appealing from the city ordinance to the commission. The appeal necessitated appraisal of all the property used and useful in Lima service, the preparation of many exhibits as to operating expense and earnings, and weeks of hearings before the commission. These expenditures are all set forth in Company Exhibit 102. (R. 542, 345-6).

There was no attack upon these expenditures in the rate case hearings. The witness for the city did not claim that the amount of the expenditures was unreasonable, but eliminated all rate case expenditures from his exhibit as to operating cost upon the erroneous view that the law did not permit such expense to be taken into account in determining rates. (R. 454-5). This was clearly a mistake in his understanding of the applicable legal principles, a fact that both the state court and counsel for the commission recognized.

The commission did not make any finding that the expenditures were not reasonable and necessary, nor did it refer to any elimination of the item of expense. It seems plain that the failure to take the expense into account was an oversight growing out of a neglect by the commission and its staff to make themselves familiar with the record in the case.

The state court held that a six-year basis of amortization would be proper. In view of the fact that the recent ordinance was, of course, passed after this case closed, and the fact of its enactment does not therefore appear in the record, we do not intend to argue further the point that

the five-year basis was the only just one. The effect either way on the rate of return is not determinative in this case.

The state court further took the position that even though the rate case expense were overlooked entirely the rate order need not be set aside. This, we submit, is clearly error. The necessity of making this expenditure increased costs, and reduced the already inadequate return earned, by an amount equal to more than one-fourth of one per centum a year on the rate base. This is a very substantial amount when a return has been limited in the manner attempted in this case.

Furthermore the rate case expense item is merely one of numerous improper deductions or omissions in determining operating expenses that the commission has made. If a sufficiently high rate of return had been allowed certain of these, standing alone, might not be sufficient, no matter how erroneous the act of disregarding it was, to necessitate a reversal of the final commission order. It must be self-evident, however, that the accumulation of even small errors cannot be overlooked, especially in a situation where, as in the case at bar, there are no compensating errors in the other direction. Some of the omitted items here complained of are, standing alone, of sufficient importance to render the rate order invalid in any event. Others, taken alone, might be of non-controlling importance. But, the accumulation of such errors in this case, has created a situation in which the company has most obviously been deprived of a compensatory return.

We respectfully submit that the treatment of general and miscellaneous expense by the commission is untenable; that its action in respect to this item must be set aside; and that, in fixing rates, the full amount of such expenditures as shown by the evidence to have been made, must be taken into account in determining the net earnings of the company from Lima service.

6. Excise Tax Expense.

The company assigns as error the fact that the commission in determining net earnings and return disregarded the fact that commencing with 1932 the excise taxes which had to be paid by the company to the state of Ohio were increased about $4,200.00 a year. In its opinion the state court asserts, page 313, that this assignment was not seriously pressed by the company. (R. 24). Such a representation is incorrect. The action of the commission in this regard was assigned as error and the assignment was fully presented and vigorously urged before the state court.

The facts about the situation may be quickly stated. By statute enacted in 1932, the excise tax payable by public utilities in Ohio was increased from 1.35% of gross revenue to 2.35% of such revenue. (See Appendix C, pp. 208-9). The first increased tax was paid in 1932. The fact of such increase was shown in the evidence. (R. 348-9). On the basis of 1932 revenues additional tax attributable to expenses in rendering Lima service would be about $4,200.00 a year.

The commission ignored the increase entirely. This, we submit, as was pressed before the state court, was an arbitrary disregard of an actual and substantial item of operating expense. The amount of such additional tax in 1932 must be taken into account in deciding this case.

7. Retirement Reserve Allowance.

We turn now to consider the rulings of the commission and the state court as to allowances for depreciation reserve and for the amortization of the company's transmission main. We recognize, in the light of this court's decisions at its last term, there is a burden on a utility of presenting proof as to the clear necessity of these reserves in the amount claimed. (See: *Dayton Power & Light Co. v.*

Public Utilities Commission of Ohio, 292 U. S. 290 (1934); *Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio,* 292 U. S. 398 (1934)). But these decisions (which were handed down long after hearings in this case closed and while the appeal was pending in the state supreme court) do not, we submit, give the commission any *carte blanc* authority to act arbitrarily on this matter, or to disregard the situation disclosed by the evidence. Yet such is the nature of the commission action in the case at bar.

The commission reduced by more than $28,000.00 a year the amount set up by the company for retirement reserve (designated "depreciation charge" in the commission opinion). This made a total additional reduction in operating expenses of more than $140,000.00 for the five-year period. Such reduction in the reserve allowance is not warranted under the evidence.

The company's evidence shows that during each of the years in question, except 1931, it set up in its retirement reserve account for the Lima district, $53,639.00. (R. 530-6). The 1931 reduction was but a temporary measure taken because of the heavy decline in revenues for that year. The company contends that in determining rates in this case, retirement reserve allowance for that year should be at the normal figure. (R. 535, 331-2). If the commission had considered the 1932 report of the company, along with the others, the fact would have appeared that in 1932 there was $53,639.00 set up for retirement reserve.

The amount charged to the reserve was, except for 1931, at the rate of approximately 3% on the *depreciated* value of the depreciable property as appraised by the commission in 1925. (R. 521). The commission had several times before considered the matter of a fair annual operating expense allowance to this company and its pre-

decessor for retirement reserve purposes, and concluded that annual charges on a 3% basis were fair and reasonable.

In re West Ohio Gas Company, 22 Ohio D. R. 121 (1925).

In re West Ohio Gas Company, 24 Ohio D. R. 527 (1926).

In re West Ohio Gas Company, 24 Ohio D. R. 535 (1926).

In re Lima Natural Gas Company, Commission Cause No. 2360.

The purpose of the depreciation charge is "to compensate the utility for property consumed in service" and the utility is entitled to have this charge spread fairly "over the years of the life of the property."

United Railways and Electric Company of Baltimore v. West, 280 U. S. 234, 254 (1930).

It is entitled as a matter of law to deduct from revenues "before coming to the question of profit at all" adequate sums to protect it fully against the exhaustion of its property in service. This fact was first pointed out by this court in *City of Knoxville v. Knoxville Water Company,* 212 U. S. 1 (1909). In the plainest possible terms, the court there stated the principle that is now settled beyond question, pages 13-14:

> "Before coming to the question of profit at all the company is entitled to earn a sufficient sum annually to provide not only for current repairs but for making good the depreciation and replacing the parts of the property when they come to the end of their life. The company is not bound to see its property gradually waste, without making provision out of earnings for its replacement. It is en-

titled to see that from earnings the value of the property invested is kept unimpaired, so that at the end of any given term of years the original investment remains as it was at the beginning. It is not only the right of the company to make such a provision, but it is its duty to its bond and stockholders, and, in the case of a public service corporation at least, its plain duty to the public. If a different course were pursued the only method of providing for replacement of property which has ceased to be useful would be the investment of new capital and the issue of new bonds or stocks. This course would lead to a constantly increasing variance between present value and bond and stock capitalization—a tendency which would inevitably lead to disaster either to the stockholders or to the public, or both."

The scope of this reserve, and the factors to be kept in mind in building it up, have been expressed with great clarity by Judge Clayton in *Mobile Gas Co. v. Patterson*, 293 Fed. 208 (1923). Judge Clayton said, pages 223-4:

"When, however, depreciation reserve is considered, allowance must be made not only for depreciation of the best units which will survive and be on hand at any given time in the future, but provision should also be had for replacements of the poor units which will be sooner consumed or discarded as no longer economical. The proposition does not differ materially from the matter of life insurance, where it is plain that the average life of a given number of individuals will be less than the life of those individuals who outlive the others, from which it follows that the average premium necessary to provide the funds with which to pay the loss upon each life must be much higher than the premium which would be necessary to provide indemnity to the individual who would, in fact, live beyond his normal expectancy. In the same way, the annual depreciation suffered by those parts of

a gas plant which will survive is necessarily much less than the average depreciation which will be suffered by the whole, including those parts which will perish or have to be abandoned for economic reasons. So I cannot accept the defendant's conclusion that the depreciation reserve intended to provide a fund for the restoration of all parts of the gas plant as they perish or become inadequate or unavailable for any cause should be estimated at the same percentage as the depreciation which has actually occurred in those particular units which have survived the others. My conclusion is that a depreciation reserve of 2.5 per cent. to cover future obsolescence, inadequacy, and depreciation is *very conservative.* A depreciation reserve of 2.5 per cent. upon $2,000,000 is $50,000, * * *."

And the fact that annual charges at about such rate are fair and reasonable has been frequently decided by the authorities:

City of Belleville v. St. Clair County Gas & Electric Company, P. U. R. 1915F 235 (3%).

City of Winona v. Wisconsin-Minnesota Light & Power Co., 276 Fed. 996 (1921) (2½%).

City of Bellingham v. Puget Sound Power & Light Company, P. U. R. 1921E 5 (3½%).

Mobile Gas Co. v. Patterson, 293 Fed. 208 (1923) (2½% on cost new).

Re Jackson County Light, Heat & Power Company, P. U. R. 1926D 737 (2.75%).

City of Manitowoc v. Wisconsin Fuel & Light Company, P. U. R. 1927D 737 (3%).

Wichita Gas Company v. The Public Service Commission, 126 Kan. 220 (1928) (3%).

Fort Worth Gas Co. v. City of Fort Worth, 35 F. (2d) 743 (1929) (3.6%).

But regardless of whether the commission was required on this record to allow in operating expenses the full amount claimed by the company, it is plain that the limitation of the reserve allowance to the hopelessly inadequate amount of $24,518.00 that was fixed by the commission cannot be upheld. The city admitted that at least $35,579.32 should be allowed annually, and produced evidence to support such fact. Even if the company's evidence were ignored entirely (a thing that cannot legally be done), the record would require that the charge of $35,579.32 be allowed annually. And the rule of "*de minimis*" referred to by this court in *Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio,* 292 U. S. 398 (1934), cannot apply here. The difference between the lowest reserve allowance possibly warranted under the evidence ($35,579.32) and the allowance made by the commission ($24,518.00) is more than $11,000.00. This sum reduces by more than 58/100ths of 1% a return that was already at a destructively low rate.

The witness for the city on this subject, Mr. Allensworth, claimed to have determined from an exhaustive and careful study the allowance of $35,579.32 advocated by him. (R. 582-9, 441-3). No one who reads the record would ever charge Mr. Allensworth with suggesting too high an allowance for the company on any item.

Mr. Allensworth's testimony, which, as has been stated, is the only evidence that could possibly be relied upon as a basis for reducing the amount actually set up by the company, is here reproduced in full:

> "Q. The next item is the item of $35,579.32 depreciation?
>
> A. Yes.
>
> Q. Is that figure found on the books of the company?

A. It is not.

Q. How do you arrive at that?

A. By making a study of the various classes and kinds of property comprised in the property used and useful in distributing gas to the city of Lima and taking thereon an annual charge for each particular class of property, of weighting that against the amount of property in each particular class, which produces the annual charge for depreciation so shown on this page in the amount of $35,579.32. That is in fact 1½ per cent of the Commission's final finding as to reproduction cost of property used and useful in the distribution of gas to Lima consumers.

Q. That is a theoretical figure?

A. Yes.

Q. This Commission has made a finding of the rate of depreciation to be used in arriving at present value of this property. I will ask you to state, Mr. Allensworth, whether in arriving at the figure of thirty-five thousand dollars plus, $35,579.32, you used the figures as found by this Commission.

A. I did. The Commission in making its finding as to sound value or reproduction cost less depreciation, found first reproduction cost, second the amount of depreciation on the various classes and kinds of property, and lastly the reproduction cost less depreciation. The amount of depreciation as found by the Commission is studied, divided by the years of life of the various classes of property which would give the annual rate of depreciation as found by the Commission in its final order as its sound value. That is proof of the rate at which the property has depreciated as such depreciation is found and reached by the Commission. Those facts, together with other facts, were taken into consideration in making this determination of 1½ per cent of the Commission's reproduction cost as being a proper annual charge for depreciation.

Q. So I understand that that rate is comparable to the depreciation found by this Commission in this case in arriving at the valuation?

A. Yes, it is.

COMMISSIONER BRICKER: You have not taken just the arithmetical figure from the amount in the depreciation reserve and calculated that as against the remaining life of the property?

THE WITNESS: No, sir.

COMMISSIONER BRICKER: Have you taken into consideration those unobserved elements of depreciation which the statute contemplates in arriving at your annual charge?

THE WITNESS: Yes, sir.

Q. (By Mr. Light.) As a matter of fact from the books of the company what is the expense experience of the company on depreciation?

A. The actual experience of the company in meeting the expense of depreciation over the seven-year period 1925 to 1931, was at the rate of 59/100 of 1 per cent per year *of the company's book value* of the property. The average for the last five years, that is five years ending December 31st, 1931,—the actual experience of the company in keeping its expense of depreciation is one-half of one per cent of the company's book value of property. That is the company's experience on the property as a whole and not segregated to the city of Lima. For the information of the Commission, *if the company's actual experience is measured in terms of the Commission's finding as to reproduction cost, its actual experience is* 9/10 *of* 1 *per cent per year* in meeting this charge for depreciation, whereas the allowance I have made in my set-up is 1½ per cent per year."

It will be seen from the foregoing excerpt that the amount allowed by Mr. Allensworth was an amount deemed by him to be just sufficient to meet the annual realized depreciation and leave in the reserve for each year an addi-

tional amount equivalent to the average annual depreciation in value as found by the commission in its valuation order. This difference was the reason for the difference between the averaged realized depreciation of 9/10ths of 1% of cost of reproduction and the allowance of 1½% on the cost of reproduction that Mr. Allensworth made. Certainly no lower allowance than the city suggested could possibly be sustained. That represents the very minimum, and it gives nothing for that margin of safety to which the company is fairly entitled.

The principle followed by the city witness on this phase of the case was fundamentally sound. The quarrel which we have with his testimony is not with his general principle, but with his losing sight of some essential factors. His error is due to his neglecting the facts that there were no substantial retirements in the short period that he considered, that the period he took was too brief to give a fair picture of the average annual realized depreciation on this type of property, and that the average life which he assumed for the property was obviously much in excess of what the actual average life would be. Consequently his allowance is inadequate.

As has been pointed out by this court, the charge for this purpose "resembles a life insurance premium. The depreciation reserve, to which it is credited, supplies insurance for the plant against its inevitable decadence, as the life insurance reserve supplies the fund to meet the agreed value of the lost human life." (*Pacific Gas & Electric Company v. San Francisco*, 265 U. S. 403, 423 (1924).)

In making his calculation of an annual allowance of $35,579.32, the witness for the city assumed that the actual average annual retirement experience for the property would remain as low as that indicated by the company's six years' experience. This assumption is not warranted.

The very low rate of retirement indicates such fact. And we trust that the court will again pardon us for a suspicion, —that perhaps one of the reasons why the commission was unwilling to put in evidence the 1932 report of the company was because it tended to give confirmation to the unsoundness of Mr. Allensworth's premise. Before one can reach a reasonably safe annual realized depreciation average, one must be able to take into account a period long enough to include the retirement of at least some of the larger units of property. Unless the company being considered has available that experience, and the period taken into account includes such major retirements, the assumed average is bound to be, as is the one here taken, far lower than the real one.

That this is true in the instant case is amply illustrated by consideration of the following facts. The reserve allowance made by the commission would be adequate only if the entire depreciable property of the company had an *average* useful life of more than 95 years.* The amount of reserve allowance admitted proper by the city, would in fact be adequate only if the company's depreciable property had an *average* useful life of more than 65 years.** Even under the reserve allowance that the company is asking, an *average* useful life of more than 44 years is necessary before the reserve proves sufficient.*** When

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*NOTE A: Determined by dividing $2,345,459.15 (the reproduction cost of the depreciable property as found by the commission adjusted for net additions to the end of 1930) by the annual reserve allowance of $24,518.00 made by the commission. Possible factor of net salvage not considered.

** NOTE B: Determined on basis stated in Note A, with $35,579.32 used as divisor.

*** NOTE C: Determined on basis stated in Note A, with $52,539.40 used as divisor.

one considers the many substantial items in the property account of the company, such as meters, services, gas manufacturing apparatus, general equipment and automobiles, whose useful lives are far below even the *average* under the company's retirement charge rate, it is plain that the allowance taken by the management is conservative, and that there is no justification for any revision thereof. For example, the evidence shows that the original gas manufacturing sets installed in Lima have been entirely replaced. The two 8'6" gas sets now in use were installed in 1910, and the 9'0" set was completed in 1924. (R. 248, 556-7). And the commission in this case has indicated that in its opinion the use of the existing gas manufacturing plant should be discontinued. (R. 90).

The conservative nature of the charge is also made clear by consideration of the following:

> Sailers "Depreciation, Principles and Application" (1923), pages 537-9.
>
> Depreciation Studies, Preliminary Report of the Bureau of Internal Revenue, Treasury Department, January, 1931, pages 1-2, 29, 33.

We desire to stress again that an allowance of less than the $35,579.32 which the city's evidence supported is wholly contrary to any evidence in the case; and under the evidence is clearly too low. The chief witness for the city testified that $35,579.32 a year was the proper allowance. There is much in the record to show that this amount is too low. There is nothing whatsoever in the record upon which to predicate the approval of anything less. The evidence of the city's witness shows that the actual experience of the company in making retirements during the seven years of its existence was at the rate of 9/10ths of

1% a year on the *cost of reproduction new* as fixed by the commission in this case. Translated into dollars, this testimony is that the average annual retirements of the company over the seven-year period would equal approximately $20,250.00. (See commission valuation order; R. 84A). This leaves but $15,000.00 a year, approximately, to protect the diminutions of the investment through accrued depreciation in the property not yet retired and to care for increases in the retirement rate.

The commission engineers found that such accrued depreciation in the property devoted to Lima service was in excess of $491,000.00 at the time of their inspection. (R. 629). Even if it be assumed that retirements would continue, and had always been, at as low an average rate as was the experience during the seven years of company history to 1931, *more than thirty-two years* would be required, under the depreciation rate advocated by the city's witness, to accumulate sufficient moneys to offset the accrued depreciation which the commission has found to exist in the property *now*.

With the same assumptions, there would, under the rate fixed by the commission in its order, be only about $4,000.00 a year to apply toward offsetting accrued depreciation in property in service. At this rate it would take *more than 120 years* for the company to secure a sum of money equal to the amount by which the commission has reduced its rate base because of alleged accrued depreciation *now existing*.

We submit that, in sustaining the commission action as to the depreciation allowance, the state court not only has lost sight of the fact that there is no evidence to support the limiting of the allowance to the inadequate sum of $24,518.00, but also has disregarded the fact that the situation which the evidence shows would exist under such a limited allowance proves conclusively that such allowance

is hopelessly insufficient. On the present record any allowance below $35,579.32 a year is arbitrary, invalid, and contrary to any evidence whatsoever.

We further submit that in determining net earnings in this case, there should be taken into account as an item of expense, the $52,539.40 annual retirement reserve allowance claimed by the company.

8. Allowance for Amortization of Pipe Lines.

The commission eliminated entirely from operating expenses allowed the company, the item of amortization of its investment in its gas transmission main or pipe line. This item is one previously allowed by the commission in fixing rates. The court upheld the commission treatment of the item.

The state court's ruling as to amortization appears to have been based on two things. First, that it had been decided in the case of *Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio,* 127 Oh. St. 169 (1933), that the Ohio statute did not permit the commission to make an allowance for amortization; and, secondly, that it was unfair to permit the amortization allowance if the value of the property was included in the rate base.

Since the decision by the state court in the *Columbus* case, this court has decided in *Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio,* 292 U. S. 398 (1934), that the federal constitution requires that an amortization allowance be taken into account in a situation where confiscation would result if such allowance were not made. We submit that under the circumstances of the case at bar, the commission could not legally reduce the rates unless there were excessive earnings after allowing a fair amount for the amortization item.

The allowance for this item was claimed by the company under the following circumstances: In 1922 it ap-

peared that natural gas could not long be obtained for use in connection with serving Lima. The company had a gas pipe line extending eastward 44 miles from Lima where it connected with the pipe line of an independent company having a natural gas supply. Because of the then unavailability of sufficient natural gas and the fact that it appeared likely that within a few years no natural gas could be obtained by the company and the pipe line would therefore be rendered useless, the company asked and obtained from the commission permission to amortize its investment in this pipe line. (R. 520-1). The commission erred, however, in estimating future revenues, and the company revenues, under rates fixed, were never large enough to permit it to earn any of the amortization allowance. In none of the years since the company has operated has it earned from Lima service sufficient to give it a reasonable rate of return. (R. 528B). It has, therefore, never obtained from its rates this amount for amortization. In spite of this fact, the company has each year since its organization, except in 1931, set up on its books an item of amortization of the pipe line equivalent to one-half of the amount authorized by the commission. In view of the lack of earnings, this item, of course, came out of the already unduly low return earned by the company, and was not, as was intended, an additional amount contributed by the rate payers who used the property.

Statements in the opinion of the state court show that that court took the position that the company was seeking to amortize the property through operating expense and also to include that same property in the rate base on which it insisted it was entitled to a return. If such were the situation, the court's criticism would be entirely sound. But that is not the case. As has been stated, the evidence establishes that in the past the company has never had

sufficient earnings to enable it to amortize any part of the transmission main except by taking a portion of its inadequate earnings for that purpose. (R. 528B). Such reserve as the company did set up was made possible by a sacrifice by the owners of the company of a part of their already grossly inadequate return. It was not a capital contribution by the rate payers. In valuing the property the commission reduced the transmission main valuation by more than $132,000.00 upon the sole theory that an order authorizing amortization had been made. (R. 84A, 300-1). Through this reduction, $132,000.00 of the value of the property devoted to the public service was arbitrarily taken out of the rate base. In this situation, fairness and equity requires the allowing of the amortization item until $132,000.00 has been returned to the owners of the property. It would be a gross denial of justice to the investors in the property if the rates of the company were reduced prior to the time that the rate payers have contributed, in addition to a compensatory return, an amount which with interest equals the $132,000.00 by which the valuation of the company's property has been reduced. The equity of the case is all on the side of the company. We submit further that the requirements of the fourteenth amendment necessitate the making of the allowance under the situation shown by the evidence here.

We believe the state supreme court has refused to give due weight to these facts. We submit that in view of them and in the light of the recent decision of this court in the *Columbus* case, an allowance for the item of amortization must be made.

The exclusion of the item will not serve to make the rate order a constitutional one. There are many other factors that necessitate a reversal of the rate order. That such is the fact, does not, however, warrant judicial ap-

proval of the commission's treatment of the item. It should, properly, be deducted in determining net return, and this court should so rule.

IV.

The State Supreme Court Erred in that it Did Not Find that the Commission, in Computing the Return Earned by the Company, Failed to Calculate Accurately what the Revenue of the Company would be for the Ordinance Period either under the Existing Rates or under the Rates Provided in the Rate Order.

The commission has used as a basis for all of its calculations an assumed average annual revenue derived by the company from gas utility service in Lima throughout the ordinance period of $482,904.50. (R. 121). This is obviously greater than the actual revenue was, and the record, in spite of the commission's refusal to consider the facts as to 1932 revenues and expenses, indicates clearly that the average taken is too large.

The commission based its average on revenues for the four years ending with 1931. The record shows that 1930 revenues were approximately $20,000.00 below those of 1928 or 1929, and that 1931 revenues were about $54,000.00 below those for either of such years. The company was denied an opportunity to show the fact that revenues were still lower in 1932 (R. 110), but without such showing, such fact would be fairly assumed in the light of the generally known experience in the utility and other business fields during that year. Anyone who reads, knows the effect of economic conditions upon utility revenues in 1932, particularly during the last half of the year. Furthermore, the commission had this fact before it in the 1932 annual report of the company, which it arbitrarily ignored

while considering the other reports. The truth is that the 1932 revenues from Lima service were, under existing rates, but about $11,000.00 more than the $416,000.00 of revenues that the commission claims would remain after a refund of about $60,000.00 for the year; and the company was prepared to show these facts if the commission had not denied a rehearing. (See R. 108, petition for rehearing, assignment No. 31. See also, pp. 27-8, *supra*).

But even on the record as it now stands, it was error to assume the average earnings for the ordinance period were the average shown by the four-year test. The least that could be justified would have been the according of a double weighting to the reduced revenues of 1931.

Likewise, the commission over-estimated the revenue that would remain to the company if the rates named in the rate order were established for the five-year period. The commission made no estimate as to the effect of the rate as applied to the fifth year of operations. Nor did it in its opinion give any clew to the method by which it concluded how much the revenues for the first four years would be. The first disclosure of this was in the brief of counsel for the commission. (See Appendix A, pp. 170, 170A, *infra*). This revealed that errors of calculation and disregard of the facts had brought about an erroneous estimate, and that, correctly figured, the revenues for the four-year period would average $416,225.04 under the commission rates instead of $428,509.47. The necessity of making this correction was admitted. (See Appendix A, pp. 177-9, *infra*); but the state court apparently disregarded the fact in reaching its decision. (R. 32). That court likewise lost sight of the fact that revenues for 1932 would be far below the average of $416,225.04.

V.

The State Supreme Court Erred in that it Upheld a Rate Order under which the Company would Not have Earned a Compensatory Return. To Avoid Confiscation an Annual Return Greatly in Excess of the Return that would have been Earned under the Commission Rates must be Allowed. Even Existing Rates Did Not Give the Company a Compensatory Return during the Ordinance Period.

We think it is clear from the foregoing discussion that the unjustified reduction or elimination of items of operating expense necessarily renders invalid, and calls for a reversal of, the rate order of the commission in this case.

The record shows that the rates ordered in effect by the commission would produce an average revenue of approximately $416,000.00 a year during the first four years of the ordinance period. (Appendix A, pp. 179A, 183A, *infra*). The true operating expenses of the company averaged slightly more than $384,000.00 a year for the four-year period, pp. 64-5, *supra*. If these actual costs are considered, there remains for return, under the commission order, about $32,000.00 a year, or 1.7% on the commission valuation of the company's property, exclusive of net additions since March, 1928. The order is clearly violative of the fourteenth amendment of the federal constitution, and, of course, cannot be sustained.

The fact is that under existing rates the company has not earned during the four-year period the 6% annual return that the commission apparently recognized was the minimum the company should have. Under present rates Lima service during the four years produced an average annual net return for the company of less than $99,000.00, or about 5.2% on the $1,901,696.26 valuation fixed by the commission in this case. And if the commission had permitted the facts to be shown, the company would have established that earnings in 1932 were only about 4%

on the valuation. Yet the commission by its order has attempted to compel the company to refund approximately two-thirds of these meager net earnings.

It cannot be seriously contended that a return of even 5.2% is high enough to be lawful or fair for this company. Under existing rates the company has never had sufficient earnings to justify the payment of common stock dividends as high as 4% in any year, and during four of the eight years of its existence, it has paid no common stock dividends whatsoever. (R. 553-4). The total surplus of the company accumulated under existing rates was, at the end of 1931, less than $40,000.00, p. 51, *supra.*

At the outset of our discussion of this issue of an adequate return, we desire to set out a brief summary of the net earnings that would appear to exist as different groups of operating expenses are excluded in figuring net returns. This will serve to correlate the effect of the disregard of the different items of actual expense that has been attempted by the commission.

We shall summarize first the real situation at the end of 1931.

Taking into account the actual operating costs of the company, the net earnings available for return and the return on the rate base (unaugmented by net addition since 1928) would, under existing rates, be as follows for the four years considered by the commission (See pp. 21-2, *supra*):

Year	*Net Earnings*	*Per Centum Return on Rate Base of $1,901,696.26*
1928	$117,634.68	6.19%
1929	98,617.09	5.19%
1930	99,451.52	5.23%
1931	79,083.12	4.16%
Average	98,696.60	5.19%

As shown on page 22, *supra,* the earnings for 1927 were but $86,837.08, which was a return of but 4.5% on the rate base established in this case and a return of but 3.9% on the rate base fixed in the 1925 rate case. (R. 520).

The commission refused to give the company an opportunity to show the facts as to earnings for 1932. (R. 110-1).

We shall summarize next the various situations which would exist if the commission rate order were applied to the four-year period and some or all of the operating expenses disregarded by the commission be left out of account in determining net return.

(a) It is only as a result of clerical errors, which are clearly disclosed by an analysis of the record and which have been heretofore discussed in detail, that an apparent average annual return of 6.65% for the four-year period is obtained under the commission rates. The undisputed facts in the record, as well as counsel's admissions, establish these errors and we may therefore disregard without further comment the claim in the commission order that the rates directed to be put into effect would have produced any such return for the period.

(b) If actual operating costs as shown in the evidence by the company were all considered, the return for each of said four years under the commission rates would be as follows:

Year	*Net Earnings*	*Per Centum Return on Rate Base of $1,901,696.26*
1928	$ 49,104.36	2.58%
1929	32,132.96	1.69%
1930	31,262.38	1.64%
1931	15,622.74	0.82%
Average	32,030.61	1.68%

(c) If operating expenses be limited as attempted by the commission but rate case expense be taken into account (i. e., approximately $71,500.00 of actual expenses being disregarded), apparent return for each of said four years under the commission rates would be:

Year	*Amount considered as available for Return*	*Per Centum Return on Rate Base of $1,901,696.26*
1928	$116,100.11	6.11%
1929	103,128.51	5.42%
1930	107,152.58	5.63%
1931	88,116.96	4.63%
Average	103,624.54	5.45%

(d) If operating expense be limited as attempted by the commission and the rate case expense which was overlooked by the commission be also disregarded (*i. e.*, approximately $77,500.00 of actual expense being omitted for each year), then under the commission rates the apparent return for each of said four years would be:

Year	*Amount considered as available for Return*	*Per Centum Return on Rate Base of $1,901, 696.26*
1928	$121,131.11	6.37%
1929	109,837.51	5.78%
1930	111,863.58	5.88%
1931	94,825.96	4.99%
Average	109,414.54	5.75%

(e) If all the company's actual cost for gas produced and purchased, distribution expense, commercial expense, new business expense and general and miscellaneous expense be taken into account, but retirement reserve allowance be limited to the $35,579.32 as advocated by the city,

and no allowance be made for the amortization of pipe lines, then under the commission rates the apparent return for each of said four years would be:

Year	*Amount considered as available for Return*	*Per Centum Return on Rate Base of $1,901, 696.26*
1928	$ 89,000.42	4.68%
1929	72,029.01	3.79%
1930	71,158.43	3.74%
1931	55,518.79	2.92%
Average	71,926.66	3.78%

(f) If all the company's actual cost other than retirement and amortization reserves be taken into account, and the retirement reserve be limited to the amount of $24,518.00 taken into account by the commission and no allowance be made for amortization of pipe lines, then under the commission rates the apparent return for each year over the four-year period would be:

Year	*Amount considered as available for Return*	*Per Centum Return on Rate Base of $1,901, 696.26*
1928	$100,061.70	5.26%
1929	83,090.29	4.37%
1930	82,219.71	4.32%
1931	66,580.07	3.50%
Average	82,987.94	4.36%

We think it evident from the foregoing tables that even if the commission were upheld in every attempted elimination of operating expense, the rates fixed by the commission are confiscatory and limit the return of the company far below the minimum return at which it can legally be compelled to serve. We submit further that most, if not

all, of the attempted eliminations of expense are improper and illegal. We submit also that even under existing rates the company did not obtain an adequate and compensatory return and that in such a situation it could not be legally compelled to refund to its customers any portion of the revenues that it had received during that period.

As this court has many times pointed out, it is essential in determining what is a confiscatory regulation of rates "to consider the actual effect of the rates imposed in the light of the utility's situation, its requirements and opportunities."

Smith v. Illinois Bell Telephone Company, 282 U. S. 133, 160 (1930).

Wabash Valley Electric Co. v. Young, 287 U. S. 488, 501-2 (1933).

Los Angeles Gas & Electric Corp. v. Railroad Commission of California, 289 U. S. 287, 319-20 (1933).

United Railways and Electric Company of Baltimore v. West, 280 U. S. 234, 249-252 (1930).

Bluefield Company v. Public Service Commission, 262 U. S. 679, 692-5 (1923).

This rule has been frequently repeated and applied by the federal statutory courts and the state courts that have been called upon to decide issues of confiscation. We call the court's attention to a recent application of it by a federal statutory court in Ohio.

Ohio Associated Telephone Co. v. Geiger, 3 F. Supp. 997, 1004 (1933).

The undisputed evidence shows that the company is now paying 7.07% per annum for capital funds secured through the sale of bonds; and 8% per annum for such funds pro-

cured through the sale of preferred stock. Its average annual cost for the capital moneys raised through the sale of preferred securities is about 7.50%.

All the securities of the company have been *authorized* by this commission, and issuance thereof was approved after a valuation of the properties to be acquired by the company had been made. This valuation was made less than four years before the passage of the ordinance involved in this case. Those securities were limited by the value of the property then determined by the commission. But 50% of the securities authorized to be issued were bonds and preferred stocks. (R. 553).

The evidence further shows that a limited amount of money, which was secured, again with the commission's approval, for capital purposes by the sale of bonds in 1931, is costing the company approximately 6½% per annum.

In its opinion the state supreme court has given but scant consideration to this vital issue of a compensatory return. Its sole discussion of the problem is a confused reliance upon a portion of the decision of this court in *Ohio Utilities Company v. Public Utilities Commission of Ohio,* 267 U. S. 359 (1925), which does not touch the subject of rate of return, but considers the question of an adequate allowance for the undistributed overhead item of "interest during construction" to be taken into account in estimating the cost to reproduce the property. (R. 32).

The state supreme court did, however, comment critically upon the high cost of capital required in rendering the service. In so doing it has apparently closed its eyes to the unavoidable factors that caused this situation. Lima is located in the northwestern part of the state, in territory where (until within the last three years), natural gas was not available in sufficient quantities to make possible any assured or satisfactory supply, pp. 10-2, *supra.* During

the years when the company's predecessors attempted to give natural gas service, the supply that could be had was uncertain and oft-times inadequate when most needed. The inescapable result was that there was curtailment in use, and even then in order to make the supply stretch as far as possible, a frugal use of the product by consumers was essential. The inadequacy of supply finally led to the necessity of a choice between continued inadequacy of service or the installation of manufactured gas service. The company, with the approval of the commission after public hearing and less than three years before the rate ordinance here involved, changed over to a manufactured gas. That its service since has been a most satisfactory one to consumers is clearly shown. (R. 130-2, 143-5, 156).

If one is to deal intelligently with this matter he cannot overlook, as the state court apparently has, the fact that late in 1924, the commission, after a public hearing, authorized the issuance of the company's outstanding securities and the payment of such interest rate as it found to be necessary in order for the company to secure capital funds. Likewise the commission passed upon and authorized the bond issue in 1931, when $300,000.00 of additional capital funds, which cost 6½% per annum, were sold.

It must not be forgotten that the past financial history of the utility involved did not enable the company to find a market for its securities at low rates of interest. As the state supreme court found in *City of Lima v. The Public Utilities Commission,* 106 Oh. St. 379 (1922), one of the predecessors of the West Ohio Gas Company had in twenty years of operations declared but two dividends on common stock. These were each 10%, making an average return on common stock of about 1% a year for the twenty-year period. The other gas company in Lima in 1920 had increased rates sustained by the state supreme court, and

the opinion shows that even those rates provided only the actual costs of operation, without any substantial amount for return. (*City of Lima v. The Public Service Commission,* 103 Oh. St. 501 (1921).) The present management of the company has improved the situation to such a degree that existing rates provide some, though an inadequate, return. Even so, the earnings are not such as to enable the company to command a ready market for its securities or to obtain new capital at a low price. And certainly the ability of the company to attract investors has not been benefited, but has been seriously handicapped, both by the unreasonable rate ordinance of the city and by the attempt on the part of the commission in this case to destroy even the inadequate earnings which the company has had.

In 1925 the commission found that in order for rates to be reasonable, they must be established on a basis designed to produce at least a 7.8% annual return. (R. 521). The commission in its order greatly overestimated the probable revenues of the company, and the estimated return was never earned.

As we have heretofore pointed out, the company, although it averaged common stock dividends of less than 2% a year during its eight years of operations, had left for surplus a total amount of less than $40,000.00 at the end of 1931. Yet the commission in this case has fixed rates requiring refunds totaling more than $330,000.00 in Lima alone.

As the table on page 131, *supra,* shows, the return which the company has received under the rates fixed in the 1925 order is, and has been, for each of the four years considered by the commission, actually at a rate far less than the cost of procuring the capital invested in the business, or even the cost of that portion of such capital as was secured through the sale of bonds. The company is

entitled to a return at a rate greater than the cost of money raised by senior security issues. This has been pointed out by this court in the clearest of terms.

In *McCardle v. Indianapolis Water Company,* 272 U. S. 400, 419 (1926), it was said:

> "It is obvious that rates of yield on investments in bonds plus brokerage are substantially less than the rate of return required to constitute just compensation for the use of properties in the public service. Bonds rarely constitute the source of all the money required to finance public utilities. And investors insist on higher yields on stock than current rates of interest on bonds. Obviously, the cost of money to finance the whole enterprise is not measured by interest rates plus brokerage on bonds floated for only a part of the investment. The evidence is more than sufficient to sustain the rate of seven per cent. found by the commission. And recent decisions support a higher rate of return."

In *United Railways and Electric Company of Baltimore v. West,* 280 U. S. 234 (1930), it was held that the utility was entitled to establish the rates it had proposed, which would yield to it a return of approximately 7.44%, and that the imposition of rates yielding less than this would be confiscatory and in violation of the federal constitution. This court held that the commission-imposed rates which would produce a return of 6.26% were clearly inadequate, and said that it was not certain but that, if the company insisted, rates securing a return of 7.5% or even 8% on the value of the property would be necessary in order to avoid confiscation. After commenting upon the fact that for moneys borrowed since 1920, the company had been compelled to pay an average rate in excess of 7%, this court said, pages 251-2:

"It is manifest that just compensation for a utility, requiring for efficient public service skillful and prudent management as well as use of the plant, and whose rates are subject to public regulation, is more than current interest on mere investment. *Sound business management requires that after paying all expenses of operation, setting aside the necessary sums for depreciation, payment of interest and reasonable dividends, there should still remain something to be passed to the surplus account; and a rate of return which does not admit of that being done is not sufficient to assure confidence in the financial soundness of the utility to maintain its credit and enable it to raise money necessary for the proper discharge of its public duties.* In this view of the matter, a return of 6.26 per cent. is clearly inadequate. In the light of recent decisions of this Court and other Federal decisions, it is not certain that rates securing a return of 7½ per cent. or even 8 per cent. on the value of the property would not be necessary to avoid confiscation. But this we need not decide, since the company itself sought from the commission a rate which it appears would produce a return of about 7.44 per cent., at the same time insisting that such return fell short of being adequate. Upon the present record, we are of opinion that to enforce rates producing less than this would be confiscatory and in violation of the due process clause of the Fourteenth Amendment."

And in *Bluefield Company v. Public Service Commission*, 262 U. S. 679 (1923), the court in holding unconstitutional a rate order designed to limit return to 6% said, pages 693-5:

"The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support

its credit and enable it to raise the money necessary for the proper discharge of its public duties. • • •

"Investors take into account the result of past operations, especially in recent years, when determining the terms upon which they will invest in such an undertaking. Low, uncertain or irregular income makes for low prices for the securities of the utility and higher rates of interest to be demanded by investors. The fact that the company may not insist as a matter of constitutional right that past losses be made up by rates to be applied in the present and future tends to weaken credit, and the fact that the utility is protected against being compelled to serve for confiscatory rates tends to support it. In this case the record shows that the rate of return has been low through a long period up to the time of the inquiry by the commission here involved."

Numerous decisions passing on the question of confiscation through rate orders, establish the necessity of the allowance of an 8% return if confiscation is to be avoided in imposing rates on the utilities involved. Many of these were cited by this court in support of its statement in the *West* case in 1930 as to the necessity of a 7.5% or 8% return for that company. Many of them cover rates attempted to be fixed during or presumably for at least a part of the period covered by the rate ordinance in this case. And most of them involve utilities larger and with opportunities to secure money upon terms decidedly better than those which the company in this case could possibly have.

Wichita Gas Co. v. Public Service Commission of Kansas, 2 F. Supp. 792 (1933). (8%).

Denver Union Stock Yard Co. v. United States, 57 F. (2d) 735, 745, 754 (1932) (7½%).

United Fuel Gas Co. v. Public Service Commission of West Virginia, 14 F. (2d) 209, 212 (1926); aff. 278 U. S. 322 (1929) (8%).

New York Telephone Co. v. Prendergast, 36 F. (2d) 54, 67-9 (1929) (7% for telephone companies is proper even though gas and electric companies entitled to 8%).

Interborough Rapid Transit Co. v. Gilchrist, 26 F. (2d) 912, 924-5 (1928) (8%).

Brooklyn Borough Gas Co. v. Prendergast, 16 F. (2d) 615, 622, 638 (1926) (8%).

Kings County Lighting Co. v. Prendergast, 7 F. (2d) 192, 194-5, 218; aff. 272 U.S. 579 (1926) (8%).

New York & Richmond Gas Co. v. Prendergast, 10 F. (2d) 167, 186-7 (1925) (8%).

Southern Bell Tel. & Tel. Co. v. Railroad Commission of South Carolina, 5 F. (2d) 77, 88-89 (1925) (8%).

Brooklyn Union Gas Co. v. Prendergast, 7 F. (2d) 628, 672 (1925) (8%).

Consolidated Gas Co. of New York v. Prendergast, 6 F. (2d) 243, 273-4, 280 (1925) (8%).

Springfield Gas & Electric Co. v. Public Service Commission of Missouri, 10 F. (2d) 252, 255 (1925) (8%).

New York & Queens Gas Co. v. Prendergast, 1 F. (2d) 351, 370 (1924) (8%).

New York Telephone Co. v. Prendergast, 300 Fed. 822, 826 (1924) (8%).

City of Minneapolis v. Rand, 285 Fed. 818, 830 (1923) (7½%).

Mobile Gas Co. v. Patterson, 293 Fed. 208, 221 (1923) (8%).

Southwestern Bell Telephone Co. v. City of Ft. Smith, 294 Fed. 102, 108 (1923) (8%).

Brush Electric Company v. City of Galveston, 262 U. S. 443, 445 (1923) (8%).

Galveston Electric Company v. City of Galveston, 258 U.S. 388, 400 (1922) (8%).

Lincoln Gas & Electric Light Company v. City of Lincoln, 250 U.S. 256, 267 (1919) (7% to 8%).

In the recent *Wichita Gas Co.* case, *supra,* the federal court made its finding as to necessary return, as follows (Finding XVIII) (2 F. Supp. 792, 810):

> "A return of approximately 8 per cent. upon present values is necessary, under present conditions, to assure confidence in the financial soundness of the Cities Service Gas Company, to maintain its credit, and to enable it to raise money necessary for the discharge of its public duties. Any return substantially lower than that would be confiscatory. *United Railways & E. Co. v. West,* 280 U. S. 234, 252."

And in explanation of the basis of the finding it pointed out, pages 810-11, that a gas utility

> "• • • must find a market in a highly competitive field. It competes with coal and fuel oil in household heating and for industrial purposes; the competition of fuel oil is particularly formidable for household heating; improved oil burners are automatic, approved by the National Board of Fire Underwriters for safety, are as clean as gas, and dependable. Electricity has absorbed the household lighting and is making serious inroads on cooking. In short, it must search for and find its gas; transport it hundreds of miles without an hour's interruption; then find and satisfy its customers. The law contemplates that it make no more than a fair

return in good times; it should not be forced to take less, when times are hard. • • •

"What is a proper return is a question of fact in which the elements of time and place play an important part. In this part of the Middle West, it is a recognized fact that in normal times, public utilities must promise a return of approximately 8 per cent., if capital for construction and extensions is to be attracted from other investments. • • • The witness for the commission testified that 8 per cent. would not be an unreasonable return in normal times, but testified that these times are abnormal, as they are. But if abnormality is considered, the return must be increased, not decreased. In these times, when stock of the best utilities can be purchased on a 9 per cent. basis or better, certainly an 8 per cent. return on this hazardous enterprise is not unreasonable."

We have not lost sight of recent decisions of this court and other courts upholding rates of return substantially lower than the return which in our judgment must be allowed in the case at bar.

Lindheimer v. Illinois Bell Telephone Co., 292 U. S. 151 (1934).

Dayton Power & Light Co. v. Public Utilities Commission of Ohio, 292 U. S. 290 (1934).

Nor would we want this court to think that we challenge the sound principle that in passing upon this question of return, the court in determining the issue of confiscation, and the commission in determining whether a reasonable return is something above the line of confiscation, should give due weight to general economic conditions as they existed from time to time through the period for which the rates were effective. We do submit, however, that this court should not lose sight of the fact that the present rate

order is retroactive and assumes to fix rates for 1928, 1929 and 1930 as well as for 1931 and 1932.

Undoubtedly these and other recent decisions will be strongly relied upon here by counsel for the commission just as they were in the state court. Counsel will, we presume, urge here as there that the decisions are blanket approvals of returns as low as the return (whatever that amount may be), which they may seek to establish that the commission allowed the company in the case at bar.

We desire to point out, however, that in those decisions the courts have not lost sight of the fundamental fact that, while the factor of general economic conditions is to be carefully weighed, it is equally true that the financial situation of the specific company involved, and its financial history and the price that it is having to pay for its capital, are likewise factors of prime importance in determining the confiscation level. These recent decisions have in no sense departed from the sound and long-followed view that what may be a compensatory return for one company will be inadequate and confiscatory for another and that the problem in each case includes the financial needs as shown by the facts there established.

For example, *Wabash Valley Electric Co. v. Young,* 287 U. S. 488 (1933), involved an electric property that operated through extensive territory. Its capital was supplied through the sale of securities of a parent corporation, which the opinion indicates had a ready and favorable market. After reasserting, in the language of *United Railways and Electric Company of Baltimore v. West,* 280 U.S. 234 (1930), the test of adequacy of return:

> "• • • that sound business management required that after paying all expenses of operation, etc., 'there should still remain something to be passed to the surplus account;' and that a rate of

> return which did not admit of that being done was not sufficient to enable a utility to maintain its credit and raise money for the proper discharge of its public duties"

this court examined the financial situation of the company which showed that it had accumulated a surplus of over $1,250,000.00 as compared with a total stock and funded debt liability of about $4,500,000.00, and concluded that the return which would be earned under the rates fixed and which was estimated to have been "much in excess of 7 per cent on the value fixed" during the period considered by the master and the lower court, was sufficient to avoid confiscation.

Again, in *Los Angeles Gas & Electric Corp. v. Railroad Commission of California,* 289 U. S. 287 (1933), the rates attacked had been fixed on a basis to produce at least a 7% return on the fair value of the property as determined by the commission. This was a 7.7% return on the historical cost of the property, since in that case the fair value fixed by the commission was nearly 10% higher than that historical cost. This court determined that the return allowed was compensatory as applied to that company. It reached its conclusion after a review of the general principles hereinbefore discussed, and grounded its conclusion upon the assertion that "applying these principles, and *considering the financial history of the company,*" the court could not conclude that the return allowed was so low as to be confiscatory. The financial history of the company is discussed by the court near the beginning of its opinion. In the body of the opinion the court states:

> "The growth was financed by the sale of the company's bonds and preferred stock. These, according to the finding of the Commission, had been

> marketed at a gradually lessening cost so that, at the time of the hearing which resulted in the order under review, it was found that the 'annual cost of its bond and preferred stock money' was 6.17 per cent."

And in a note the court says:

> "Note No. 1.—Reviewing the financial history of the Company, the Commission found: 'On Dec. 31, 1929, the company had outstanding in the hands of the public $47,070,000 par value of bonds, $19,469,995 par value preferred stock, and $20,000,000 par value of common stock. Its depreciation reserve on that date was reported at $16,804,105.15. All of its common stock is owned by Pacific Lighting Corporation. Since 1916 but $4,500,000 of this stock has been purchased for cash, $5,500,000, however, having been distributed to Pacific Lighting Corporation in the form of stock dividends, representing earnings left in the property. Dividends have been paid on its common stock of 7.20 per cent per share ($100 par value) in 1916, 1917, and 1918; 7.4 per cent in 1919; 8.4 per cent in 1920, 1921, and 1922; 8.7 per cent in 1923; 33.75 per cent in 1924, included in which is 25 per cent as a stock dividend of $2,500,000; 9 per cent in 1925; 9.815 per cent in 1926; 35.17 per cent in 1927, which includes a stock dividend of 21.42 per cent, or $3,000,000; 15 per cent in 1928, and 17 per cent in 1929. The company's surplus has grown from $381,212.97 in 1916 to $4,176,663.09 in 1929, while its depreciation reserve increased from $3,804,383.36 to, as said above, $16,804,105.15.' 35 C. R. C., pp. 447, 448."

The essentialness of keeping fully in view the actualities of the situation in the specific case being presented has been emphasized again in this court as recently as the decision in *Lindheimer v. Illinois Bell Telephone Co.*, 292

U. S. 151 (1934). This court there reviewed fully the financial history of that company and then pointed out that "this actual experience of the Company is more convincing than tabulations of estimates." Summarized, in the language of this court in the prior appeal of that case, that history showed that the cost of capital to the Illinois company was low enough, that under existing rates it had been able

> "• • • to expand its business so as to meet increasing demands, to pay its operating expenses including interest on money borrowed, to pay dividends of eight per cent. upon its capital stock and to accumulate a surplus." *(Smith v. Illinois Bell Telephone Company,* 282 U. S. 133 (1930).)

The final decision re-asserts the sound fundamental that in a confiscation case rate of return is not a matter to be decided by a blind application of a percentage, but by a study of the situation of the company whose rates are under attack. This principle applies with as much force in a case where its application requires the sustaining of existing rates, as it does in a case where its application justifies a reduction.

We believe that an application of the principles to which we have called the court's attention necessitate the reversal of any order of the commission that attempts to impose on the company a rate that would not produce an annual return of at least 8% for the rate period. If so, it is evident that even the existing rates were not compensatory. But regardless of whether or not the court approve that view, the fact here is that any return that would be produced under the rates fixed by the commission order is so low as to destroy any basis for rationally claiming that the order can be upheld.

VI.

The State Supreme Court Erred in Not Finding that the Validity of the Rate Order must be Determined by its Effect on Net Earnings from Year to Year; and that the Rate Order and the Order to Refund were Invalid because this Requirement had not been Complied with.

The commission paid no attention to the commonly known fact that general economic conditions subsequent to 1931 were far worse than in 1931. This is a fact of which the courts and commissions take judicial notice. (*Atchison, Topeka & Santa Fe Railway Co. v. United States,* 284 U. S. 248 (1932); *Dayton Power & Light Co. v. Public Utilities Commission of Ohio,* 292 U. S. 290 (1934)). The commission assumed a situation in 1932 equal to the *average* of the four preceding years. This assumption was made in the face of evidence showing that both revenue and net return in 1931 were far below the four-year average. Not only that, but when, after the end of 1932, the company offered to show the facts for that year, the commission refused to hear them. (R. 530, 110-1).

The average annual net earnings for the four years, 1928 to 1931, both inclusive, are not a measure of the net earnings for the year 1932 and subsequently, and such fact is plainly demonstrated by the record. The rate fixed by the commission, even if it were sustainable for the four years prior to 1932, could only be deemed to produce a fair return for 1932 upon the assumption that the situation in 1932 would be the same as the *average* of the four preceding years. The record shows this assumption to be wholly unwarranted. It shows that net earnings from Lima district service for the year 1928 were 50% higher than those for 1931, and that net earnings for the years 1929 and 1930 were approximately 25% higher than those for the year 1931. (R. 530). It shows that in 1931 gross revenue

from Lima district service was $46,962.32 less than the average revenues for the three preceding years, and was $35,-221.74 *less than the average revenues for the four-year period of 1928 to 1931, both inclusive.* 1931 net earnings and gross revenue were, therefore, far below the four-year average. In view of the marked downward trend in economic conditions during the year 1932 and at least a part of the year 1933, it could not reasonably be assumed that the earnings of the company during 1932 would equal an average based on four years, *three* of which were, relatively speaking, the "fat years" referred to by the state court. The fact was that earnings for 1932 were substantially below those for 1931, and this the company offered to show in its petition for rehearing.

When these realities are kept in mind, it is apparent that the rate fixed by the commission could not in any event be lawfully forced upon the company for the year 1932 and subsequently. The validity of the rates for the period subsequent to the period considered by the commission in fixing the rates, must be determined by testing their current effect. The rates can be sustained for that part of the ordinance period subsequent to the period considered only if it can reasonably be found that they would produce an adequate return during that time.

Lindheimer v. Illinois Bell Telephone Co., 292 U. S. 151 (1934).

Smith v. Illinois Bell Telephone Company, 282 U. S. 133 (1930).

Atchison, Topeka & Santa Fe Railway Co. v. United States, 284 U. S. 248 (1932).

Galveston Electric Company v. City of Galveston, 258 U. S. 388, 400-1 (1922).

Banton v. Belt Line Railway Corp., 268 U. S. 413, 418 (1925).

We think under the authorities, it is likewise clear that, as to the entire past period in controversy, no rate or rates fixed, and no refund ordered, can be sustained as to any past year unless under such rates and after such refund the company would have earned a return during such year high enough to be non-confiscatory.

We submit that the commission method of attempting to make the rates applicable to an extensive past period and to whatever future period they are to apply, and its manner of determining the question of refunds due, is in conflict with the requirements laid down by this court. The validity of the rates through the past must be determined by testing their effect in each year in which it is attempted to apply them.

This court has long asserted the rule that the validity or invalidity of a rate ordinance at any time depends upon its actual effect at such time.

Thus in *Galveston Electric Company v. City of Galveston*, 258 U. S. 388 (1922), the court said at pages 400-1:

> "A rate ordinance invalid when adopted may later become valid, just as an ordinance valid when made may become invalid by change in conditions. *Municipal Gas Co. v. Public Service Commission*, 225 N. Y. 89, 96. Compare *Willcox v. Consolidated Gas Co.*, 212 U. S. 19; *Newton v. Consolidated Gas Co.*, ante, 165."

See also:

> *Banton v. Belt Line Railway Corp.*, 268 U. S. 413, 418 (1925).

And this principle has been frequently applied in framing decrees in cases when no present confiscation was found:

> *City of Knoxville v. Knoxville Water Company*, 212 U.S. 1, 19 (1909).

Lincoln Gas & Electric Light Company v. City of Lincoln, 250 U. S. 256, 268 (1919).

Willcox v. Consolidated Gas Company, 212 U. S. 19, 55 (1909).

Brush Electric Company v. City of Galveston, 262 U. S. 443, 446 (1923).

The decision of *Smith v. Illinois Bell Telephone Company*, 282 U. S. 133 (1930), further clarified the scope of this principle, and determined that where a controversy as to rates extends over a considerable period and a rate or rates are fixed applicable to the past period of controversy, the validity of such rate as applied to any year of this period must be determined upon the basis of its actual effect during such year.

In the *Smith* case, this court was dealing with the question of the validity of a commission rate order, as applied not only to the future but also to a seven-year past period during which higher rates had in fact been collected. It held that the validity of the rate order as to that part of the period in controversy which had passed, must be tested from year to year. It said, page 162:

> "A rate order which is confiscatory when made may cease to be confiscatory, or one which is valid when made may become confiscatory at a later period. *Des Moines Gas Company v. Des Moines*, 238 U. S. 153, 172, 173; *Lincoln Gas Company v. Lincoln*, 250 U. S. 256, 268, 269; *Brush Electric Company v. Galveston*, 262 U. S. 443, 446; *Bluefield Company v. Public Service Commission, supra.* In view of this fact, and *as the disposition of the amount withheld by the Company under the conditions of the interlocutory injunction will depend on the final decree*, there should be appropriate findings as to the results of the intrastate business in Chicago and the *effect of the rates* in question *for*

each of the years since the date of the Commission's order."

The mandate there given is plain. The federal statutory courts that have been called upon to apply it, have found no ambiguity in its directions.

Illinois Bell Telephone Company v. Gilbert, 3 F. Supp. 595 (1933).

Ohio Associated Telephone Co. v. Geiger, 3 F. Supp. 997 (1933).

In the latter case an Ohio federal statutory court applied the principle in a proceeding where a period of approximately six years was involved. The court, holding that the master erred in considering a single year's period only as the basis for testing the rate schedule, proceeded to find the net earnings during each year of the period. It said, page 1004:

> "The following rates of return are thus found: 5.60 per cent. (1925), 5.90 per cent. (1926), 6.17 per cent. (1927), 6.98 per cent. (1928), 7.61 per cent. (1929), 7.99 per cent. (1930), and 8.12 per cent. (1931).
>
> "It is interesting to note that this gives an average per cent. over the period of 6.93 per cent., which is slightly lower than that found by the court, based upon 1930 calculations, and about eight-tenths of 1 per cent. lower than that determined by the master. This rate as applied to the case under consideration is considered to be well within constitutional requirements.
>
> "No fixed rule as to rate of return can be laid down which would apply uniformly to all sorts of utilities (*United Railways v. West,* 280 U. S. 234, 249, 250, 50 S. Ct. 123, 74 L. Ed. 390) and very likely to utilities of the same class, but differently situated, as the equities would depend upon circum-

stances, locality, and risk, and other considerations. While neither set formulae nor mathematical accuracy are possible of attainment, in the consideration of such questions account must be taken of the rule that a rate order which is confiscatory when made may cease to be confiscatory, and vice versa. *Smith v. Illinois Bell Telephone Co.*, 282 U. S. 133, 162, 51 S. Ct. 65, 75 L. Ed. 255; *Des Moines Gas Co. v. Des Moines*, 238 U. S. 153, 172, 173, 35 S. Ct. 811, 59 L. Ed. 1244; *Bluefield Co. v. Public Service Commission*, 262 U. S. 679, 43 S. Ct. 675, 67 L. Ed. 1176. With more than five years under inquiry, divided into seven periods, showing a rate of return on an ascending scale, and dealing with this case and its equities alone, it may be fairly concluded that the rates of return shown for 1925, 1926, and 1927 do not measure up to the constitutional requirements, and that those beginning with the year 1928 are immune from constitutional defect.

"It is so ordered."

We submit that the principle is controlling in this case, and that it is essential to apply it before any refunds of moneys collected in the past under established rates can be lawfully ordered. And, *a fortiori*, it must be applied to the years of the ordinance period not taken into account in the averages.

VII.

The State Supreme Court Erred in Not Holding that the Rate Order is Invalid because the Commission Refused to Grant the Company a Rehearing, Suitably Requested.

In support of this claim of error the company insists:

(a) It should have been permitted an opportunity to show on rehearing what the facts were as to its revenues, expenses and net earnings for the year 1932 and such part of 1933 as had elapsed prior to the date of the commission order; and

(b) If any of the annual reports of the company were to be made a part of the record, that the annual report for the year 1932 should have been included and the company should have had an opportunity to make what showing it deemed necessary in reference to that report. (We have already discussed the illegality of the action of the commission in respect to the use of the annual reports for the years 1928 to 1931, both inclusive, pp. 55-62, *supra*).

The company in its petition for rehearing requested the commission to receive such evidence, but the request was denied. The action of the commission in this respect was arbitrary, and would be prejudicial to the company in the event the commission rates were sustained on the present record. We shall discuss separately each of these claims.

(a) The evidence as to 1932 operations was not available when the hearings closed. The evidence as to 1931 showed clearly that, unless there was a decided improvement in economic conditions, earnings for 1932 would be far below any four-year average ending in 1931. That business conditions in 1932, especially during the last half of the year, were far worse even than in 1931, is a matter of such common knowledge as to warrant judicial notice. (See: *Atchison, Topeka & Santa Fe Railway Co. v. United States,* 284 U. S. 248, 260-2 (1932), *supra.*) The company had no reason to suppose either that the commission would ignore that reality, or that it would fail to give weight to the evidentiary facts of record that revenues and net return in 1931 were far below the average since 1927, and were decreasing. Upon finding from the commission order that the factor of the present had been ignored, the company promptly pointed out such fact, and also asked an opportunity to show its greatly reduced revenues during and since 1932. The making of such a showing became essential because of the nature of the

commission order and the commission's action in refusing to take into account the fact, which the record discloses, that earnings had been greatly diminished under the existing economic situation. The petition for rehearing set forth the fact that the business of the company had been further adversely affected by such economic conditions, and that the company would show that its earnings for the year were far below the average of the four years considered by the commission.

On page 313 of its opinion, the state court justifies the refusal of the commission to allow the company to show the effect of 1932 operations upon the ground:

> "To have considered the year 1932 would have required the Commission to revamp all the work it had done, and we do not think it abused its administrative discretion in refusing the application." (R. 25).

This is a recognition that the facts as to existing conditions would have shown that the averages of the past four years on which the commission relied were inapplicable to conditions in 1932 and subsequently.

In its ruling the state court overlooked controlling legal principles. As a result of the petition for rehearing it became the legal duty of the commission to receive the evidence. It must be apparent that when the figures were before the commission the work of revising its averages would not have been an extended task and the recognition that revision would have been required must also be a recognition that the rates already fixed could not have been constitutionally extended to 1932 operations if the facts as to earnings for that year were established. Even if there had been any prospect that the rehearing requested might have been long, it would not have justified the commission in denying the rehearing when the same was required by

essential demands of justice. We urge that as a matter of right, the company was entitled to make this showing before any order reducing its rates could lawfully be made. Such a view is sustained by the *Atchison Railway Company* case, *supra,* where this court set aside a rate reduction order of the Interstate Commerce Commission because that body had denied the carriers a rehearing to show the severe decrease in revenues suffered between the date of the closing of the hearings and the date of the order. In the opinion in that case it was said (284 U. S. 248, 262):

> "We are thus brought to the fundamental considerations governing the authority of the Commission. It has broad powers and a wide extent of administrative discretion, with the exercise of which, upon evidence, and within its statutory limits, the courts do not interfere. The important and salutary functions of the Commission to enforce public rights are not to be denied or impaired. But the Commission, exercising a delegated regulatory authority which does not have the freedom of ownership, operates in a field limited by constitutional rights and legislative requirements. Its duty * * * with respect to the prescribing of reasonable rates and the preventing of unreasonable or unjustly discriminatory or unduly preferential practices, has not been changed by the Hoch-Smith Resolution. *Ann Arbor Railroad Co. v. United States,* 281 U. S. 658, 669, 50 S. Ct., 444, 74 L. Ed., 1098. The legal standards governing the action of the Commission in determining the reasonableness of rates are unaltered. In the discharge of its duty, a fair hearing is a fundamental requirement. *Interstate Commerce Commission v. Louisville & Nashville Railroad Co.,* 227 U. S. 88, 91, 33 S. Ct. 185, 57 L. Ed. 431. In the instant proceeding, the hearing accorded related to conditions which had been radically changed, and a hearing, suitably requested, which would have permitted the presentation of

evidence relating to existing conditions, was denied. We think that this action was not within the permitted range of the Commission's discretion, but was a denial of right. The order of the Commission which was thus made effective, and the ensuing supplemental order, cannot be sustained."

(b) As we pointed out in the statement of facts, during the hearings the commission offered no evidence as to the expenses and net earnings of the company. The evidence on these matters thereafter introduced by it, consists solely of the four annual reports of the company for the years 1928, 1929, 1930 and 1931 that were put in the record without notice to the parties by an order dated three days before the final order was entered. At that time the commission had in its possession the company's annual report for the year 1932. Its failure to include that report in the record is hard to understand. Its refusal so to do, when the matter was specifically called to its attention, is utterly incomprehensible. Such refusal is not alone shocking to one's sense of equity and fairness, it savors inescapably of a deliberate attempt to ignore the reality of the facts. If this case, or any feature thereof, should be dependent on knowing the facts as to 1932 operations, then this court should require that the commission make this last report a part of the record, and give the company an opportunity to introduce such evidence in reference to the relevant matters contained therein as it may deem necessary.

VIII.

The State Supreme Court Did Not Make that Independent Judicial Review of the Law and the Facts which Due Process and Equal Protection of the Laws Require.

We do not question the salutary principle that in a judicial review of administrative action, courts do not interfere

with the exercise of a wide administrative discretion, if action within that realm is founded upon evidence sufficient to support it. This court has recently restated the same rule in pointing out that "for the legislative process, at least equally with the judicial, there is an indeterminate penumbra within which choice is uncontrolled."* We think it clear that nothing more than this was stated by this court in *Atchison, Topeka & Santa Fe Railway Co. v. United States,* 284 U. S. 248, 262 (1932), which was referred to by the state court in the case at bar.

The fact that the foregoing rule is true, cannot, however, furnish a justification or pretext for a court, when appealed to in a confiscation case, failing to perform its duties within the sphere reserved to it.

The judicial functions in confiscation cases have been clearly and repeatedly set forth by the decisions of this court.

The kind of a judicial review that should have been given in the case at bar was succinctly described in *Ohio Valley Water Company v. Ben Avon Borough,* 253 U. S. 287 (1920), where this court in reversing a judgment of the Supreme Court of Pennsylvania said, page 289:

> "In all such cases," (rate fixing orders) "if the owner claims confiscation of his property will result, the state must provide a fair opportunity for submitting that issue to a judicial tribunal *for determination upon its own independent judgment as to both law and facts;* otherwise the order is void because in conflict with the due process clause, 14th Amendment. * * * Thus far plaintiff in error has not succeeded in obtaining the review for which the 14th Amendment requires the state to provide."

**Dayton Power & Light Co. v. Public Utilities Commission of Ohio,* 292 U. S. 290 (1934).

In *Ohio Utilities Company v. Public Utilities Commission of Ohio,* 267 U. S. 359 (1925), a case coming up from the Ohio commission and through the state supreme court, this court reversed the final judgment of the Supreme Court of Ohio because of its failure to accord such a review in a case where the facts did not justify the commission order, saying, page 364:

> "From the foregoing, it is evident that the state supreme court did not accord to the plaintiff in error that sort of judicial inquiry to which under the decisions of this court it was entitled."

And in the very recent case of *State Corporation Commission of Kansas v. Wichita Gas Co.,* 290 U.S. 561 (1934), this court again said, page 569:

> "And upon the issue of confiscation *vel non* they are entitled to the independent judgment of the courts as to both law and facts."

To the same effect:

Bluefield Company v. Public Service Commission, 262 U. S. 679, 689 (1923).

Prendergast v. New York Telephone Company, 262 U. S. 43, 50 (1923).

Lehigh Valley R. R. v. Commissioners, 278 U. S. 24, 36 (1928).

United Railways and Electric Company of Baltimore v. West, 280 U. S. 234, 251 (1930).

Crowell v. Benson, 285 U. S. 22, 60 (1932).

Van Wert Gaslight Co. v. Public Utilities Commission of Ohio, 299 Fed. 670, 676 (1924).

Chesapeake & Potomac Telephone Company of Baltimore v. West, 7 F. Supp. 214, 230 (1934).

It is respectfully but most earnestly urged that had the state court attempted any real compliance with this duty it could not but have found that the commission order must be set aside. We submit that the bald conclusions of the state court on questions of fact are, like those of the commission, so manifestly against, and without support by, the evidence that they abundantly show that the evidence has not been considered.

As we pointed out in our application for rehearing in the state court, and as we have stressed in this argument, the statements contained in the court's opinion show beyond question that the court failed to read the record and the exhibits.

As we further pointed out, the court's conclusions in respect to the elimination of operating expenses are contrary to the uncontradicted evidence in the case.

As we further pointed out, the court below not only failed to examine the evidence and compute the actual revenues, expenses and net earnings under the commission's rates, but it also disregarded the actual tabulations which were prepared for it. Had it paid any attention to these tabulations, or, if not satisfied as to their accuracy, had it made its own investigation, the confiscatory nature of the commission's order would have been abundantly apparent.

We respectfully submit that the company is entitled to have the judgment of the state court set aside because of that court's refusal to perform its duty of giving the company an independent judicial review of the law and the facts involved in this case.

Conclusion.

We have, perhaps, trespassed upon the time of the court in this argument, but this case is of vital importance to our client and to the many individuals whose investments are in the property used in rendering gas utility service to Lima consumers. By its confiscatory effect, the rate order threatens the very existence of the company.

We feel too that there are issues in this case which are of paramount general importance. These are whether two basic and long settled principles are to be discarded. The first of these principles is that a finding by a regulatory body "without evidence is arbitrary and baseless," and "comes under the Constitution's condemnation of all arbitrary exercise of power." *(Interstate Commerce Commission v. Louisville and Nashville Railroad Company,* 227 U. S. 88 (1913)). The second principle is that in rate proceedings the actual costs of operation cannot be left out of account in the absence of proof of their unreasonableness. On this point we once more remind the court that, as to many of the items eliminated in the case at bar, there was no suggestion of challenge during the hearings by either counsel for the city or by the commission. If, in such a situation as the record here discloses, a commission is to be upheld in disregarding the costs of rendering the service, then constitutional protection for property devoted to public use is necessarily at an end.

It is, of course, apparent that when a company in its eight years of operation has not earned any substantial surplus, in spite of the fact that it has paid an annual average dividend of less than 2% on the common stock which the commission has recently authorized it to issue, its rates are not producing and have not produced excessive earnings. It is equally apparent that no toying with

figures by the commission's accountants can transform the inadequate earnings which the company had during the ordinance period, even under existing rates, into excessive earnings of over $330,000.00. We submit that the conclusion is inescapable that confiscatory rates have been imposed upon the company.

The gas rate ordinance passed by the city of Lima in 1928 was not passed in good faith as an endeavor to fix a non-confiscatory rate for the service. This was in effect admitted by the city's own evidence. We think it is equally indisputable that the commission and the state court in this case disregarded their duties under the law, and that the company has been denied that protection against the confiscation of its property to which it is entitled under the constitution of the United States.

We submit that an analysis of the evidence as to revenues and expenses shows inescapably that, as a result of mistakes in arithmetic and analysis by its staff the commission's order reduced the net earnings of the company far below the 6% return found by the commission to be the minimum that should be allowed. One cannot escape the result, shown by the figures in the record, that, even if the commission were upheld in every expense elimination that it made, the company's earnings would average less than 5.5% for the rate period and but 4.63% for 1931, the last year analyzed.

We believe any study of the record makes it abundantly plain that most, if not all, of the operating expenses disregarded by the commission cannot be lawfully ignored. And there are in this case no compensating errors "to supply a margin for the correction" for these illegal deductions. *(Dayton Power & Light Co. v. Public Utilities Commission of Ohio,* 292 U. S. 290, 305 (1934)).

We respectfully submit that the Supreme Court of Ohio erred in refusing to set aside the rate order, and in denying protection against confiscation; and that for the reasons herein presented, the judgment of that court must be set aside on this appeal.

Respectfully submitted,

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Counsel for Appellant.

APPENDIX A.

Excerpts from briefs filed in the state court showing the arithmetical errors made by the accountants for the commission in attempting to determine the revenues under the commission rates and the amount of operating expenses under the commission theory of determining allowable expense.*

I.

EXCERPTS FROM ORIGINAL BRIEF FILED ON BEHALF OF WEST OHIO GAS COMPANY.

[65*] 2. *Distribution Expense*

The commission reduced the actual average distribution expense of the company by more than $5700 a year, or a total of $28,500 for the ordinance period. This reduction was made by assuming to find the average distribution expense per customer during the period for all communities served by the company, and multiply this by the average number of customers in Lima. (Commission Opinion, p. 4). The average distribution expense figure obtained by the commission by this method was $3.52 per customer, but we shall hereafter show that a true average was not found by the commission.

* * *

[69*] 3. *Commercial Expense*

The actual commercial expense for the company for the Lima district as shown by the books of the company was

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*NOTE: Star paging denotes page numbers in briefs filed in the state court.

reduced by the commission more than $800 a year, or $4,000 for the five-year period. This method of reduction was ac[70*]complished in the same manner as the reduction for distribution expense (Commission opinion, p. 4), and for the same reasons heretofore given, the commission method cannot be sustained.

* * *

5. *General and Miscellaneous Expense*

* * *

[77*]

b. The Commission Overlooked a Substantial Part of the General and Miscellaneous Expense.

In attempting to find the averages for this expense, the commission accountants failed to examine the reports carefully and missed part of the general and miscellaneous accounts. The company had reported these as called for in the printed instructions. General and miscellaneous expense in connection with artificial gas service is re-[78*] ported on page 32 of each annual report under the heading "VI—General and Miscellaneous Expenses." The classification for natural gas service is somewhat different, the general and miscellaneous accounts, being included among items under two headings, viz.—"H. General Administrative Accounts" and "I. Other General Expense Accounts." In building up its averages, the commission overlooked entirely the general expenses reported under heading "I." That the commission was inadvertent is shown by the fact that all items of general and miscellaneous expense (except deferred ones) were taken into account for 1931, in which year the company, with the approval of the commission, reported all its expenses under the artificial gas expense classification. (Commission Exhibit 4 of March 8, 1933, pp. 31-2.) The amounts thus overlooked

(after making allowance for items reported under heading "I" that on the company's accounting records [Company Exhibit 104], and in the commission opinion are treated separately, i. e., depreciation, amortization of pipe line, uncollectible consumers accounts, and indirect charges to construction) are $11,206.91 for 1928; $17,018.20 for 1929; and $7,047.83 for 1930. (Commission Exhibits 1, 2 and 3 of March 8, 1933, pp. 35-6.)

c. The Commission Failed to Find a True Customer Average for the Four-Year Period.

Even if it were proper to determine this expense in connection with Lima service by the process of "customer averages," the averages found by the commission are not the true ones for the period, and the commission results would be prejudicial to the company and to consumers in the other communities served.

[79*] We have already under the discussion of distribution expense items referred to the fact that the commission customer averages have been erroneously determined. As to those expenses the error of the commission in reaching its averages has comparatively slight practical importance, since, roughly speaking, those expenses increase in proportion to the number and size of the communities served. That is not true of joint general administrative expenses. They are substantially fixed costs of operating the company, and do not, except in cases of drastic change, vary substantially because the number of customers or communities served changes. Consequently, an error in determining customer average produces a quick distortion in the general and miscellaneous expense attributable to any community under the commission method.

Analysis of the figure of $3.44 taken by the commission to be the company's average annual general and miscel-

laneous cost per customer for the four-year period ending December 31, 1931, discloses that the sum was arrived at as follows: The commission totaled the general and miscellaneous expenses in connection with artificial gas service and a part of those in connection with natural gas service as shown on the company's annual reports for the four years considered. It then totaled the number of customers being served by the company at the close of each of these years as shown on the annual reports. It then divided the total of customers into the total taken for general and miscellaneous costs.

Such a method would have given a fair average customer figure for Lima of that portion of the expense con- [80*] sidered, *if* during the four-year period taken the company had continued to render service only in the communities served at the beginning of the period. But that was not the case. Sometime during 1930 the company commenced serving four additional towns. In these communities it had 317 customers at the end of 1930 and 470 at the end of 1931. During 1931 it commenced service in Delphos in which at the end of the year it had 1071 customers. Obviously, in such a situation, it is impossible to arrive at a correct customer average for the four-year period, by an arithmetical average. The taking of such an average, charges a part of the expense for certain of such years to communities not then being served. A weighted average must be taken.

We shall illustrate the error by an easy example. Assume that a company during each of four years served ten customers in each of the communities, A, B and C, or thirty customers. Assume next that in the fourth year it served thirty customers in an additional community, D. Assume further that its general expense was $300 during each of the four years. In this situation, the arithmetical average

taken by the commission would give a general average cost per year per customer of $8.00 [($300 × 4) ÷ (30 + 30 + 30 + 60) = $8.00]. In other words, the general expense allocated to each of the communities of A, B and C, for the period would be $80 a year, or $320 for the four years. And the general expense allocated to D for the one year it was served would be $8 × 30 or $240 or 80% of the entire general expense for the single year that D was served. The error is, of course, that D has [81*] been charged a part of the expense for the three years it was not being served, and, correspondingly, A, B and C have been freed from a portion of the general costs that during the first three years of the period had been incurred exclusively in connection with service to them.

The proper method, of course, would have been to determine the average customer cost for each year of the period, then find out during which of the years the community being considered was given service, add the average customer costs for such years only, and divide by such number of years. The use of such a weighted average would have brought a true customer average of such expenses as were being considered. But it would have increased to a sum nearer the actual, the commission figure as to general and miscellaneous expense in Lima service, — a result that the commission was laboring hard to avoid.

Furthermore, the averages are untenable because they ignored the customer situation for 1932. Although it was fixing rates for a five-year period, including 1932, and had before it in the company's annual reports the customer data for 1932, it refused to consider such data. The reason will be obvious when the report is in evidence. There was a falling off of customers in that year.

* * *

II.

Excerpts from Original Brief filed on behalf of the Public Utilities Commission of Ohio.

[13*]

A—Rate of Return.

The table opposite shows what would have been the gross revenues of the company computed at the commission rates on the volumes of consumption as shown in Company Exhibit 105. (See p. 170A, *infra*).

* * *

[17*]

B—The Commission's Method of Using Average Expenses for the Entire Period.

The company contends that the commission erred in not treating each annual period separately. While it is true that in the final order of the commission it shows average annual expenses (p. 4 of order), these were, of course, derived from the annual statements of the company, as appears from the table opposite: (See p. 170B, *infra*).

[19*] This table clearly shows how the commission arrived at the averages used by it.

* * *

[21*]

D—Distribution Expense.

* * *

[22*]

The commission took the view that a per consumer basis was the only fair way to allocate distribution expense and also commercial expense and general and miscellaneous expense. It, therefore, took the annual reports of the company from which it developed the following:

LIMA CONSUMPTION 97.8% OF LIMA DISTRICT.

		1928		1929		1930		1931	
		Cu. Ft.	*Revenue*	*Cu. Ft.*	*Revenue*	*Cu. Ft.*	*Revenue*	*Cu. Ft.*	*Revenue*
*First	1000 cu. ft. @ 1.57 per M. c. f.....	114,280,600	$179,420.54	115,382,600	$181,150.68	112,098,000	$175,993.86	109,662,400	$172,169.97
Next	3000 cu. ft. @ .95 per M. c. f.....	170,412,800	161,892.16	172,056,200	163,453.39	167,158,100	158,800.20	163,526,200	155,349.89
Next	6000 cu. ft. @ .95 per M. c. f.....	48,265,800	45,852.51	48,731,360	46,294.74	47,344,100	44,976.90	46,315,400	43,999.29
All over	10,000 cu. ft. @ .75 per M. c. f.....	62,338,500	46,753.88	62,939,500	47,204.63	61,147,800	45,860.85	59,819,200	44,864.40
		395,297,700	$433,919.09	399,109,600	$438,103.44	387,748,000	$425,631.81	379,323,200	$416,383.55

* 1st 400 cu. ft.....$1.00
Next 600 cu. ft. @ .95 per M. c. f..... .57

$1.57

Average Revenue for 4 years.....$428,509.47
Average Total Expense 302,025.92
(See Expense Table infra.)

Average Net Return .....$1[illegible]3,483.55
Valuation Rate Base $1,901,696.25
Average Return on Rate Base..... 6.65%

[18*]

EXPENSES	*Year 1928*	*Year 1929*	*Year 1930*	*Year 1931*	*Average*
(A) Cost of Gas Sold	$145,004.00	$153,448.00	$149,143.00	$138,704.00	$146,574.92
* Distribution Expense	37,870.00	35,892.00	31,855.00	33,954.00	34,892.75
* Commercial Expense	21,496.00	19,771.00	19,369.00	19,311.00	19,986.75
** New Business Expense	8,538.00	11,051.00	11,208.00	10,342.00	(B) 5,000.00
* General and Misc. Expense	34,153.00	40,758.00	28,021.00	31,940.00	(x) 33,713.00
** Indirect Charges to Const. (Cr.) (red)	1,827.00	2,588.00	8,400.00	2,401.00	3,804.00
(C) Depreciation	24,518.00	24,518.00	24,518.00	24,518.00	24,518.00
** Real and Personal Property Taxes	23,353.00	24,889.00	23,121.00	19,826.00	22,797.25
** Ohio Excise Tax	7,034.00	7,382.00	7,259.00	6,782.00	(y) 7,014.25
** P. U. C. O. Tax	286.00	282.00	265.00	280.00	278.25
** Income Tax	10,144.00	8,867.00	6,878.00	8,127.00	8,504.00
** Uncollectible Accounts	2,768.00	2,753.00	2,228.00	2,034.00	2,445.75
Total Expenses	$313,337.00	$327,023.00	$295,465.00	$293,417.00	$301,920.92
(B) Using Commission Allowance for New Business expense	$309,799.00	$320,972.00	$289,257.00	$288,075.00	

(A) Reduction of Company figures to reflect allowance of 7% for leakage instead of 9% claimed by Company.

(B) Allowed by Commission as reasonable.

(C) 1.4% on depreciable property ($1,751,288.80) in Lima.

* Annual Report figures allocated to Lima on per customer basis.

** Allocated to city of Lima on basis of 97.8% of figures in Company Exhibit 104.

(x) Correct average should be $33,718.00
(y) Correct average should be $7,114.25
} These corrections change total average to $302,025.92.

Number of Customers (From Annual Reports.)

Year	Entire Company Average	Lima
1928	15,209	10,045
1929	15,916	10,139
1930	15,912	9,832
1931	16,183	9,152

Dividing the total amount of distribution expense shown in the annual report for each year by the number of consumers in the entire system was found a per consumer cost for this item which is multiplied by the number of Lima consumers, as shown in the above table, thus arriving at the annual allowances for distribution expense shown in the expense table which produced the average of $34,892.75. Certainly there can be nothing unfair in this method of allocation.

• • •

[23*]

E—Commercial Expenses.

The commission in computing the allowance for commercial expense again took the exact amount shown by the company in its annual reports for each of the four [24*] years examined allocated to Lima on a per customer basis. The results of these calculations are shown for each of the years in the table of expenses.

• • •

[26*]

G—General and Miscellaneous Expense.

The company contends that the commission erred in treating this account in four regards: first, that the allocation method is untenable; second, that the commission failed to find a true per customer average; third, that the commission overlooked a substantial part of such expenses shown in the annual reports, and fourth, that no rate case expense was allowed.

• • •

[28*]

2. The company contends that the commission failed to find a true customer average. In connection with their argument on this point counsel seeks to show on page 80 of company brief by example that the commission method is in error. As a matter of fact the commission did not use the method which the company shows in its example. Using the same example the commission would have found a $10.00 per customer cost per year for the first three years and a $5.00 per customer cost for the fourth year so that had it been fixing an average per customer cost in the community for the four years it would have struck an average of $35.00 ÷ 4 or $8.75 per year. The whole example is, of course, erroneous in assuming that the company expense of $300 for the first three years would have remained unchanged upon the addition of thirty additional customers. The commission actually took the total amounts shown in the company annual reports for each of the items, distribution, commercial, new business and general and miscellaneous ex-[29*] pense, divided these amounts by the number of consumers as shown for each year hereinbefore and thus found a per consumer cost for each class of expense for each year. The averages as stated by the commission on page 4 of its finding represent the averages for the four years as shown by the following table:

Per Customer Averages of Expenses.
West Ohio Gas Company—Entire System.

	1928	*1929*	*1930*	*1931*	*Average 1928-31*
Distribution Expense	$3.77	$3.54	$3.24	$3.71	$3.56
Commercial Expense	2.14	1.95	1.97	2.11	2.04
New Business	.85	1.09	1.14	1.13	1.05
Gen. and Misc. Expense	3.40	4.02	2.85	3.49	3.44

Counsel for the company state at page 81 of their brief the use of a weighted average would have brought a true

customer average of such expenses as were being considered. That is exactly what the commission did, therefore, we submit that the company is simply misinformed when it attacked the commission's findings on this ground.

3. The company contends that the commission overlooked a substantial part of the general and miscellaneous expense. They show at page 78 of their brief the amounts which they claim the commission overlooked as being $11,206.91 for 1928, $17,018.20 for 1929, and $7047.83 for 1930. They are correct in stating that the commission overlooked the amounts under heading "H" in the natural gas portion of the annual reports for 1928, '29 and '30 but it is believed they are in error as to the amounts as we are unable to find such amounts as shown. As a matter of fact, the commission accountants over[30*]looked amounts in the annual reports under the heading "H", as follows: 1928, $9784.28; 1929, $10,357.76; 1930, $11,767.88. In checking this error the commission accountants also discovered that the item of "Uncollectible Consumers' Accounts" shown in the expense table supra (page 18), was also included in the totals of general and miscellaneous expense for each of the years so that it was allowed twice by the commission. In order to show this court the effect of these two errors we submit the following:

All figures taken from Annual Reports	*1928*	*1929*	*1930*	*1931*
Gen. and Misc. Exp. used by Com.	$117,118	$129,304	$110,302	$89,161
Less Depreciation and Amortization	65,347	65,347	65,347	32,674
Less Uncollectible Accounts (Allowed separately)	4,180	4,051	3,394	3,238
Total	47,591	59,906	41,561	53,249
Plus amount overlooked (Item "H")	9,784	10,358	11,768	None
Corrected Total	57,375	70,264	53,329	53,249

Corrected Allocation to Lima on per consumer basis	37,870	44,713	32,937	30,110
Corrected Averages to Lima for General and Miscellaneous Expense				$36,407.50

The above corrected average is $2689.50 in excess of the average shown on the expense table. Adding this amount to $302,025.92 we get $304,715.42 which, deducted from $428,509.47, being the average revenue computed at the rates fixed in the commission order, leaves $123,794.05 as the average net return. This is 6.5% of the rate base. We submit, therefore, that after making these corrections the rates fixed by the commission are not unreasonable.

[31*]

4—Rate Case Expense.

The company on page 13 of its Exhibit 104 sets up a showing of $30,607.69 as rate case expense which it claims is entirely excluded from the annual report figures filed with the commission. The commission was, of course, under the impression in taking annual report figures of the company that all its operating expenses incurred as of each year appeared therein. We concur with counsel for the company that a reasonable rate case expense should be included but the same argument applies to this account as to the item of new business expense. If a company is free to make any expenditures it deems fit for the purpose of fighting a rate case it can thereby defeat any rate fixed by a regulatory body. There is no question here but that the company is entitled to a reasonable rate case expense as an operating expense inasmuch as the commission expressly found that the rates fixed in the ordinance appealed from were unjust and unreasonable (see Commission Order). The language used by a three-judge Federal

Court in an opinion denying an application for an interlocutory injunction in the case of *Ohio Associated Telephone Company v. Geiger, et al.*, No. 837, rendered in April, 1931 (unreported), is quite pertinent here. The company in that case was seeking to enjoin telephone rates fixed by the commission for the city of Marion, Ohio. The court there said:

> "Doubtless, current legal expenses, necessary or incidental to the conduct of the business, are proper items of expense. Possibly, also, where the com[32*]pany is unavoidably thrown into proceedings for valuation and rate determination before the Public Utilities Commission, reasonable charges arising therefrom may be proper in the calculation of return for the years covered; but we do not see how such a charge is relevant to a consideration of the prospective effect, upon earnings, of newly established rates. Presumably the company is not to be burdened by similar charges throughout the coming years, and obviously such charges, if resulting solely from the desire of the company to obtain a greater return than would otherwise be reasonable, cannot be said to have any integral relationship to the economic and proper conduct of the business. In determining the reasonableness of the rates prescribed by the commission this item cannot be given consideration."

There is nothing in the record to indicate the reasonableness or unreasonableness of the figures claimed by the company except as they stand in Exhibit 104. If this court is of the opinion that the matter should be remanded for consideration in this regard the commission could investigate these claimed expenses and determine their reasonableness or if this court is of the opinion that the amount as claimed should be allowed in full it would involve the addition of a proportionate amount for each year to the

commission findings on expense. While the company contends that this should be amortized entirely over the period of the rate ordinance we respectfully call the attention of the court to the fact that the rate ordinance involved here has already expired, no new action having been taken by the city council of Lima. As this will not be a recurrent expense unless [33*] and until a new rate ordinance is passed in Lima we suggest that this rate case expense be spread over a period of six years averaging $5100 per year. Adding this amount to the average expense allowed by the commission, as corrected above, we get $118,700 as the average net revenue which is 6¼% on the rate base. The court will bear in mind that the commission's obvious intent, as shown throughout its order, was to fix a rate which would return the company not less than 6% on its fair value. It is, of course, impossible to fix rates which will bring in exactly the net revenue found to produce a certain exact percentage of return. We submit, therefore, that the commission fixed rates should not be disturbed even by the addition of rate case expense in the amount shown by the company.

III.

Excerpts from Reply Brief filed on behalf of West Ohio Gas Company.

[16*]

On page 29 of their brief counsel, in explaining the nature of the several errors made by the commission in attempting to determine average general and miscellaneous expense, claim that we were in error in calculating certain amounts, which we set forth on page 78 of our original brief as sums in the general and miscellaneous account that the commission had apparently overlooked.

They say that we stated those items were from Natural Gas Account—H, and that they are "unable to find such amounts as shown." If counsel had taken the time to read our brief, this claim of miscalculation would not have been made. We did not claim the figures were from "Natural Gas Account—H". They were figures from "Natural Gas Account—I" determined in the manner plainly stated on page 78 of our brief.

• • •

[18*]

The defense to the commission order, which its counsel attempt to make in their brief, is, we believe, fairly stated as follows:

It was claimed that the commission fixed rates that it thought would give an average return of 6.65% for the ordinance period. It was admitted that there were certain deductions in operating expenses made by the commission that were based on error, and should not have been made. It was then claimed that when the admittedly necessary corrections were made, there still remained average annual earnings of about 6% per annum for the ordinance period; that a 6% annual return was the return the commission had in mind to allow, and that an allowance of a return at such average rate for the years 1928, 1929, 1930, 1931 and 1932 was high enough to avoid confiscation. Therefore, counsel argue, the order should be sustained.

Upon a study of counsel's brief, we discovered certain errors in the table of alleged earnings under the commission's rates set out on page 13 thereof. We also discovered that in the revision of general and miscellaneous expenses, which the commission accountants attempted to make and which counsel set out in the revised table of such expense shown on page 30 of their brief, there were further errors. [19*] These we called to the assistant attorney general's

attention before the oral argument. We also then directed his attention to the fact that his suggestion for a six-year period for amortizing rate case expense, which was predicated upon the claim that there was no new rate ordinance pending (Deft. Bf. pp. 32-3), was entirely unjustified in the light of the fact that the common council of the city of Lima already had had prepared a new gas rate ordinance which provides for rates even lower than those named in the prior ordinance, and which had passed first reading,—a fact which could scarcely be deemed unknown to his co-counsel who are the city attorney and assistant city attorney for Lima. We do not believe it amiss to add that the ordinance has since been passed.

The foregoing mentioned changes were the further necessary corrections which counsel stated to the court in oral argument ought to be made before the court could see what the commission had in fact attempted to do in its order.

In order to make clear the effect of these changes, we shall point out briefly the nature of each of the above mentioned errors and set forth revised tables showing the results of the various corrections.

Counsel prepared their table of earnings shown on page 13 of their brief from certain data taken from Company Exhibit 105. That exhibit was introduced in order to show the unreasonableness of the rates provided for by the city ordinance. It showed that even if the Lima ordinance rate were applied to *all* gas manufactured at the [20*] Lima plant, including that sold in Lima for house heating and that sold to or in municipalities outside of the Lima district, still the total revenues would not be sufficient to pay operating expenses applicable to Lima district service alone. The exhibit we now recognize was somewhat confusing when an attempt was made to use it for some pur-

REVENUES FROM GAS SERVICE IN LIMA UNDER COMMISSION RATES

(On basis of using per centum of sales in each step and same rates per thousand cubic feet as shown in table on page 13 of brief for defendant)

Corrections as to Quantity of Gas Sold in Lima

		Year 1928	*Year 1929*	*Year 1930*	*Year 1931*
(1)	Total sales of manufactured gas in cubic feet—shown by Company Exhibit 105	404,189,900	408,087,500	396,470,300	387,856,000
(2)	Deduct manufactured gas sales outside of Lima district—Company Exhibit 104, pp. 5 and 6	.....	.....	7,899,000	25,974,800
(3)	Deduct sales of gas for House Heating in Lima district—Company Exhibit 104, pp. 3, 4, 5 and 6	5,706,400	9,086,000	12,489,200	10,409,000
(4)	Total deductions (item 2 and item 3)	5,706,400	9,086,000	20,388,200	36,383,800
(5)	Lima district sales after above deductions (item 1 minus item 4)	398,483,500	399,001,500	376,082,100	351,472,200
(6)	97.8% of Lima district sales to city of Lima (Percentage per table in brief for defendant, p. 13). (97.8% of item 5)	389,716,900	390,223,500	367,808,300	343,739,800

Corrected Showing as to Revenues

	Rates fixed by Commission	*Year 1928* Corrected Lima Sales (cubic feet)	*Year 1928* Revenue	*Year 1929* Corrected Lima Sales (cubic feet)	*Year 1929* Revenue	*Year 1930* Corrected Lima Sales (cubic feet)	*Year 1930* Revenue	*Year 1931* Corrected Lima Sales (cubic feet)	*Year 1931* Revenue
(7)	First 1,000 cu. ft. @ $1.57 per M. C. F.	112,667,100	$176,887.35	112,813,600	$177,117.35	106,333,400	$166,943.44	99,375,200	$156,019.06
	Next 3,000 cu. ft. @ .95 per M. C. F.	168,007,000	159,606.65	168,225,400	159,814.13	158,562,200	150,634.09	148,186,200	140,776.89
	Next 6,000 cu. ft. @ .95 per M. C. F.	47,584,400	45,205.18	47,646,300	45,263.99	44,909,400	42,663.93	41,970,600	39,872.07
	All over 10,000 cu. ft. @ .75 per M. C. F.	61,458,400	46,093.80	61,538,200	46,153.65	58,003,300	43,502.48	54,207,800	40,655.85
	Totals	389,716,900	$427,792.98	390,223,500	$428,349.12	367,808,300	$403,743.94	343,739,800	$377,323.87
(8)	Add actual revenue from, and cubic feet of, sales for house heating. (See Company Exhibit 104, pp. 3, 4, 5 and 6)	5,706,400	4,304.13	9,086,000	6,527.39	12,489,200	9,251.64	10,409,000	7,607.09
		395,423,300	$432,097.11	399,309,500	$434,876.51	380,297,500	$412,995.58	354,148,800	$384,930.96

pose other than that for which it was introduced. Counsel's error in making use of it arose through their overlooking the nature and purpose of the exhibit and using blindly the tables therein set forth without thought as to their purpose or scope, and without comparing them with Company Exhibit 104 which showed the actual consumption data for the Lima district. They also fell into error because they gave no consideration to the fact that the rates named in the commission order are higher than the existing special house heating rates of the company; and that, of course, the company cannot collect back from house heating customers the difference, nor can it abrogate the existing house heating rate if it expects to retain that class of business.

From the foregoing it appears that counsel's premise as to the earnings under the commission rates is untenable and must be revised in two important respects: (a) it includes gas sales to Delphos and the northern towns (see Company Exhibit 104, pp. 5 and 6), and (b) it does not make allowance for the lower revenues from house heating sales in Lima (see Company Exhibit 104, pp. 3, 4, 5 and 6).

We submit herewith a table of revenues under the commission rates, which is similar to the one set forth on page 13 of counsel's brief, but is corrected in the manner above stated. (For table, see p. 179A, *supra*).

[21*] We have submitted the foregoing corrected table to the assistant attorney general, counsel for the commission in this case, and we are authorized by him to state that he has approved the table as showing the estimated amount of revenues that would be derived by the company for the four years ending December 31, 1931, under the rates fixed by the commission in this case.

On page 30 of their brief counsel have attempted to correct admitted errors in the treatment of general and mis-

cellaneous expense by the commission. The attempted correction is incomplete. The fact that the item of indirect charges to construction was considered as a separate item by the commission, and that therefore such item should not be used to reduce the general and miscellaneous expense account, was overlooked. This error led to an omission of an annual average of over $3,800 of general and miscellaneous expense. The calculation in this table is further in error because of the method employed by the commission accountant in determining the number of customers served by the company in total and in the Lima district. (See Deft. Bf. p. 22.) In determining the number of customers for the entire company for any year, the accountant took the mesne between the total customers reported as customers at the end of the year being considered and at the end of the immediately preceding year.* In determining the Lima district customers served for any year, that method was abandoned and merely the customers reported at the end of the year being considered were used. There is, of course, no justification for this varia[22*]tion of treatment. The commission accountant made a further mistake in that, in determining the number of Lima district customers for 1929 and 1930, he neglected to include customers in Cridersville, which is within the Lima district. There is another error. In the entire company customer averages, the number for 1928, on the basis followed by the commission, should be 15,709 instead of 15,209. When these corrections are made, the customer averages under the commission's method, instead of being those shown on page 22 of counsel's brief, are as follows:

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*NOTE: For example the company's annual reports for 1928 and 1929 showed total customers of 15,925 and 15,907, respectively. The commission accountant used 15,916 [(15,925 + 15,907) ÷ 2] as the customers for 1929.

[23*]	*1928*	*1929*	*1930*	*1931*	
General and Miscellaneous Expense used by commission*	$117,118	$129,304	$110,302	$89,161	
Less Depreciation and Amortization	65,347	65,347	65,347	32,674	
Less Uncollectible Accounts. (Allowed separately)	4,180	4,051	3,394	3,238	
Balance	47,591	59,906	41,561	53,249	
Add Indirect Charges to Construction. (Red figure—Credited separately)	2,604	3,482	12,227	3,750	
Add amount overlooked by commission. (Natural Gas Account—H)	9,784	10,358	11,768	.....	
Corrected Total	$59,979	$73,746	$65,556	$56,999	
Corrected Allocation to Lima District on corrected per customer basis as shown, *supra*, page 22	$38,705	$47,008	$41,142	$33,616	
Corrected Allocation to Lima alone. (97.8% of Lima district allocation)	$37,854	$45,974	$40,237	$32,877	
Corrected Annual Average to Lima for General and Miscellaneous Expense on basis used by commission (exclusive of unamortized rate case expense)	.....	.....	.....		$39,235

*NOTE: All figures, except those shown as allocations, are taken from annual reports.

This table has been submitted to and approved by the assistant attorney general, who is counsel for the commission in this case, as showing the amount of general and miscellaneous expense (exclusive of unamortized rate case expense) taken into account by the commission under its method of determining such expense as adopted in this case.

Year	*Average Entire Company*	*Average Lima District*
1928	15,709	10,159
1929	15,916	10,153
1930	15,912	9,986
1931	16,183	9,550

We have corrected the errors above stated to exist in the table set out on page 30 of counsel's brief. As corrected, that table shows that under the commission method of allocation the average annual allowance for general and miscellaneous expense (exclusive of unamortized rate case expense) in connection with Lima service during the four years ending December 31, 1931, would be $39,235.00. The revised table follows: (For table, see p. 181A, *supra*).

[24*] Counsel admit that the commission was in error in ignoring the rate case expense of the company, and attempt to excuse the oversight by suggesting that the commission was confused in using the annual reports. (Deft. Bf. p. 31.) There was no reason for confusion. The rate case expense item was fully set forth in the company exhibits of operating expenses and explained in oral testimony. The oversight of the commission was a result of its refusal to consider the evidence.

Counsel suggest on page 33 of their brief that the expense be spread at the rate of approximately $5,100 a year over a six-year period instead of over the five-year period of the ordinance. This suggestion is predicated upon the claim of "no new action having been taken by the city council of Lima." (Deft. Bf. p. 32). The suggestion of a six-year, rather than a five-year period can scarcely be deemed to have merit, when as a matter of fact a new rate ordinance naming rates even lower than those fixed in the 1928 ordinance had already been prepared for, and was pending before the Lima city council,— a fact that

was well known to the city attorney for Lima who appears of counsel on the brief for the commission in this case. From an equitable viewpoint, the suggestion is further untenable because of the fact that no part of the rate case expense incurred subsequent to April, 1932 is taken into account. (See Company Exhibit 104, p. 13.) We submit, therefore, that the unamortized rate case expense should be distributed equally through the ordinance period, or at the average rate of $6,101.34* a year instead of $5,100 a year.

[25*] None of the unamortized rate case expense is included in the table on page 30 of counsel's brief. Spread on the five-year ordinance term basis, this rate case expense increases the commission figure for average Lima general and miscellaneous expense during the four year period ending December 31, 1931 to the following total:

Commission calculation of average general and miscellaneous expense for Lima, exclusive of unamortized rate case expense, (*supra*, page 23)	$39,235.00
Annual allowance for unamortized rate case expense spread on five-year basis	5,790.00**
Corrected commission calculation of average annual general and miscellaneous expense plus allowance for rate case expense	$45,025.00

*NOTE: $30,607.69 ÷ 5 — $6,101.34 (see Company Exhibit 104, p. 13).

**NOTE: Amount is less than the average annual amount of $6,101.34 for the ordinance period, because only nine months of unamortized rate case expense has been charged against 1928 operations and because of credits for certain rate case expenses included in general expenses during four year period (see Company Exhibit 104, p. 13).

	Year 1928	Year 1929	Year 1930	Year 1931	Four-year Average
Revenue under commission rates, *supra*, page 21 (table)	$432,097	$434,876	$412,996	$384,931	$416,225
Portion of actual expense considered under commission method corrected for errors in calculations, and including rate case expense*	315,997	331,748	305,843	296,814	312,601
Net available for return on valuation	$116,100	$103,128	$107,153	$88,117	$103,624
Per cent. of return on valuation of $1,901,696.26, unaugmented by net additions	6.11%	5.42%	5.63%	4.63%	5.45%

* Note: Determined as follows:

	Year 1928	Year 1929	Year 1930	Year 1931	Average
(1) Total expenses (Deft. Bf. p. 18)	$309,799	$320,972	$289,257	$288,075	$302,026
(2) Deduct General and Miscellaneous expense (Deft. Bf. p. 18)	34,153	40,758	28,021	31,940	33,718
(3) Deduct Distribution expense (Deft. Bf. p. 18)	37,870	35,892	31,855	33,954	34,893
(4) Deduct Commercial expense (Deft. Bf. p. 18)	21,496	19,771	19,369	19,311	19,986
(5) Total Deductions (Sum of items 2, 3 and 4)	$93,519	$96,421	$79,245	$85,205	$88,597
(6) Balance (item 1 minus item 5)	$216,280	$224,551	$210,012	$202,870	$213,429
(7) Add corrected General and Miscellaneous expense, taken into account by commission as per table, *supra*, page 23	37,854	45,974	40,237	32,877	39,235
(8) Add corrected Distribution expense—Redetermined on per customer basis as shown, *supra*, page 22	36,265	35,151	31,643	34,651	34,428
(9) Add corrected Commercial expense—Redetermined on per customer basis as shown, *supra*, page 22	20,567	19,363	19,240	19,707	19,719
(10) Add Rate Case expense amortized over a 5 year period, per Company Exhibit 104, p. 13	5,031	6,709	4,711	6,709	5,790
(11) Total additions (Sum of items 7, 8, 9 and 10)	$99,717	$107,197	$95,831	$93,944	$99,172
(12) Total expense taken into account by commission (Sum of items 6 and 11)	$315,997	$331,748	$305,843	$296,814	$312,601

When the foregoing corrections are made, the summary as to the average annual return which would have been earned for the period ended December 31, 1931, *if* the commission rates had been in effect, and *if* the *actual* cost of service *had been only* those costs taken into account by the commission, must likewise be corrected. So corrected,

[26*] the summary which appears in the table on page 13 of counsel's brief shows the following:

Average annual revenue for four years, *supra*, page 21 (table)	$416,225.00
Average annual expenses allowed for four years on commission basis after correction of errors and inclusion of rate case expense, determined as shown *infra*, page 27 (note)	312,601.00
Average net for return for four years on commission basis	$103,624.00
Valuation—Rate base as found by commission	$1,901,696.26
Average return on valuation unaugmented by net additions	5.45%

And on the same basis, the earnings for each of those four years, on the commission valuation, unaugmented by net additions, would have been but 6.11% return in 1928; 5.42% in 1929; 5.63% in 1930; and 4.63% in 1931, as is shown by the following table: (For table, see p. 183A, *supra*).

[27*] The entire foregoing table has been submitted by us to the assistant attorney general, who is counsel for the commission in this case. At his suggestion the necessary changes were made to put the distribution and commercial expenses, taken into account by the commission, on the per customer basis as shown by the revised table,

supra, page 22. He has authorized us to state that this table has been submitted to and approved by him as correctly showing the estimated net earnings from gas service in Lima for the four year period ending December 31, 1931, under the rates fixed by the commission *if* expenses be limited to those taken into account under the methods adopted by the commission in this case.

• • •

[49*]

e. General and Miscellaneous Expense.

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If counsel's explanation of the method by which the commission accountants arrived at their average is correct, then this difference is almost wholly due to the different methods of allocation used by the company [50*] and by the commission.*

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*NOTE: In our original brief, pages 79-80, we set forth the manner in which the four-year customer averages used by the commission appeared to be arrived at. The commission accountant who made up these averages had refused to inform the company as to his method. After numerous trials we found that under the method we outlined in our brief the average of $3.44 per customer for general and miscellaneous expense, which had been used by the commission, was obtained without the intervention of any error except the failure to include the proper items under "Natural Gas Account— I." We assumed that that must have been the method pursued. Counsel state that a different method was followed; and that the result was reached by the commission accountant using a weighted average basis, and including the proper items from "Natural Gas Account—I," but making the errors of not including the items in "Natural Gas Account—H," of failing to deduct the item of "Uncollectible Consumers' Accounts" and of

IV.

Excerpts from Supplemental Brief filed on behalf of The Public Utilities Commission of Ohio after the Reargument of the Cause.

[9*].

(A) Gas Produced and Purchased (Cost of Gas Sold).

The company claims that for the four year period from 1928 to 1931, both inclusive, which was the period used by the commission on the basis of the figures available to it, that the average cost of gas produced and purchased for said period per year was $150,361.75. The commission allowed for this same period an average cost of $146,574.92, making a difference of $3,786.83. The allowance by the commission should have been only $143,578.00 for the reason that the operating statistics shown in Exhibit "A" of the commission's opinion erroneously included sales to Delphos and other items, as explained on page 21 of the company's reply brief, where corrections were made and explained as they pertained to reductions in the M c. f. of gas sold and the revenues derived therefrom. By the same reasoning, a reduction in the M c. f. of gas sold would also result in a reduction in the cost of gas sold, but no correction of this item was made in the company's reply brief. However, in preparing the above exhibit, all figures on lines 1, 2 and 3 have been corrected to eliminate all factors not pertaining to Lima, not only in respect to M c. f. of gas sold and revenues, but also in respect to cost of gas

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failing to allow credit for the item of "Indirect Charges to Construction." As to the further mistakes of the commission accountant in attempting to correct these errors, see *supra,* pages 21-3.

sold. This would result in a difference of $6,783.75 instead of $3,786.83. (See Lima Exhibit "B," p. 23.)

* * *

Corrected Rate Study.

[20*] For the convenience of the court we have prepared two exhibits designated as Lima Exhibit A and Lima Exhibit B (see pp. 21, 23) and we believe that a careful analysis of these exhibits will convince the court of the soundness of the commission's position in this case.

Analysis of Lima Exhibit A (p. 21).

This exhibit shows the differences in expenses as claimed by the company and as allowed by the commission with the corrections of the table on page 35 of the company's reply brief. It sets up the average annual expenses for distribution of gas in the city of Lima for the period from 1928 to 1931, inclusive, showing the difference between the amounts claimed by the company and those allowed by the commission. These differences have all been discussed heretofore in this brief and the table contained in this exhibit was the basis upon which the discussion of differences in operating expenses was predicated. This exhibit also contains a reconciliation with the table shown on page 35 of the company's reply brief. (For table, see p. 186A, *infra*).

[22*]

Analysis of Lima Exhibit B (p. 23).

Exhibit B shows the gross revenues from gas service in Lima which will be earned under the rates fixed by the commission, as shown in reply brief prepared by the company at page 21 thereof. This exhibit shows the gross revenues of the company for gas service in Lima for each

Lima Exhibit A.

WEST OHIO GAS COMPANY, LIMA, OHIO—SUPREME COURT OF OHIO, NO. 24104.

TABLE OF DIFFERENCES IN EXPENSES BETWEEN COMPANY AND COMMISSION CORRECTING THE TABLE ON PAGE 35 OF THE COMPANY'S REPLY BRIEF

		Average Annual Expenses for City of Lima for Years 1928-1931, Both Inclusive		
Operating Expenses:		*Company*	*Commission*	*Difference*
1.	Gas produced and purchased	$150,361.75	$143,578.00	$6,783.75—
2.	Distribution expense	40,622.11	34,428.00	6,194.11—
3.	Commercial expense	20,804.25	19,719.00	1,085.25—
4.	New business expense	12,110.20	5,000.00	7,110.20—
5.	General and miscellaneous expense	47,557.80	39,235.00	8,322.80—
6.	Indirect charges to construction—Cr.	(3,825.51)	(3,804.00)	21.51+
7.	Retirement allowance	52,539.40	24,518.00	28,021.40—
8.	Amortization of pipe line	22,935.97	.....	22,935.97—
9.	Real and personal property taxes	22,767.32	22,797.25	29.93+
10.	State of Ohio—Excise tax	7,107.79	7,114.25	6.46+
11.	Tax of Public Utilities Commission of Ohio	277.82	278.25	.43+
12.	Federal income tax	8,494.25	8,504.00	9.75+
13.	Uncollectible accounts	2,441.28	2,445.75	4.47+
14.	Total	$384,194.43	$303,813.50	$80,380.93—

( ) Indicates red figures.

Reconciliation With Table Shown on Page 35 of Company's Reply Brief:				
15.	Totals shown in company's reply brief	$384,194.43	$313,333.00	$71,699.01—
16.	Errors in footings shown in brief	.....	732.58—	105.00+
17.	Reduction in gas produced and purchased as explained in note on Exhibit "B"	.....	2,996.92—	2,996.92—
18.	Rate case expense disallowed by commission but included in table on page 35 in error	.....	5,790.00—	5,790.00—
19.	Corrected totals shown on line 14 above	$384,194.43	$303,813.50	$80,380.93—

Lima Exhibit B.

WEST OHIO GAS COMPANY, LIMA, OHIO—SUPREME COURT OF OHIO NO. 24104.

CORRECTED RATE STUDY.

		Year 1928	*Year 1929*	*Year 1930*	*Year 1931*	*Average 4 Years*
1.	M c. f. of gas sold in Lima	395,423.3	399,309.5	380,297.5	354,148.8	382,294.8*
	Revenues:					
2.	Gross revenues from gas service in Lima under commission's rates	$432,097	$434,876	$412,995	$384,931	$416,225*
	Expenses:					
3.	Cost of gas sold	145,041	153,495	146,262	129,512	143,578*
4.	Distribution expense	36,265	35,151	31,643	34,651	34,428
5.	Commercial expense	20,567	19,363	19,240	19,707	19,719
6.	New business expense	5,000	5,000	5,000	5,000	5,000
7.	General and miscellaneous expense	37,854	45,974	40,237	32,877	39,235
8.	Indirect charges to construction—Cr.	(1,827)	(2,588)	(8,400)	(2,401)	(3,804)
9.	Depreciation	24,518	24,518	24,518	24,518	24,518
10.	Real and personal property taxes	23,353	24,889	23,121	19,826	22,797
11.	Ohio excise tax	7,034	7,382	7,259	6,782	7,114
12.	P. U. C. O. tax	286	282	265	280	278
13.	Income tax	10,144	8,867	6,878	8,127	8,504
14.	Uncollectible accounts	2,768	2,753	2,228	2,034	2,446
15.	Total expenses	$311,003	$325,086	$298,251	$280,913	$303,813
16.	Net income	$121,094	$109,790	$114,744	$104,018	$112,412
	Rate of Return:					
17.	Based upon commission's valuation of $1,901,696 as of March 31, 1928	6.37%	5.77%	6.03%	5.47%	5.91%

NOTE:

* The operating statistics shown in Exhibit "A" of the commission's opinion erroneously included sales to Delphos and other items, as explained on page 21 of the company's reply brief, where corrections were made and explained as they pertained to reductions in the M c. f. of gas sold and the revenues derived therefrom. By the same reasoning, a reduction in the M c. f. of gas sold would also result in a reduction in the cost of gas sold, but no correction of this item was made in the company's reply brief. However, in preparing the above exhibit, all figures on lines 1, 2 and 3 have been corrected to eliminate all factors not pertaining to Lima, not only in respect to M c. f. of gas sold and revenues, but also in respect to cost of gas sold.

( ) Indicates red figures.

of the years 1928, 1929, 1930 and 1931. It also shows the average for the four year period. The exhibit then sets forth the expenses as set forth in the commission's reply at page 18, corrected. These expenses are shown in detail together with a total for each of the years 1928, 1929, 1930 and 1931, and with the average for the four year period. The study then shows the net income for each of the four years together with the rate of return earned in each year and the average. From this study it will be observed that upon the basis of the gross revenues as shown by the company and upon the basis of the expenses as allowed by the commission, corrected as to all mathematical and other errors, and upon the basis of the commission's valuation of $1,901,696 the company earned for the year 1928 a return of 6.37%; for the year 1929 a return of 5.77%; for the year 1930 a return of 6.03%; a return for the year 1931 of 5.47% and an average for the four year period of 5.91%. (For table, see p. 187A, *supra*).

V.

EXCERPTS FROM SUPPLEMENTAL REPLY BRIEF FILED ON BEHALF OF THE WEST OHIO GAS COMPANY AFTER THE REARGUMENT OF THE CAUSE.

[53*]

The Changes in the Operating Expenses to Be Taken Into Account, Which Are Urged by Counsel for the Commission in Order to Increase the Apparent Return from Lima Service to the 6% Per Annum Found Necessary in the Commission Order, Are Not Supported by the Evidence or Warranted Under the Law.

In their supplemental brief, counsel assert that if the rates fixed by the commission had been in effect and if

operating costs had been only those taken into account by the commission, the earnings of the company would have averaged 5.91% per annum for the years 1928, 1929, 1930 and 1931 instead of the 5.45% shown on page 26 of our reply brief. They accomplish this alleged increase in earnings by means of an erroneous claim for a further reduction at the rate of $2,996.92 per year in the item of "cost of gas produced and purchased," and by now denying that the rate case expense incurred by the company in the proceedings before the commission should be taken into account. These are the two items shown in lines 17 and 18 on their "Lima Exhibit A" appearing on page 21 of their supplemental brief, and account for the total differences between the net income and percent return shown on the sheet following page 26 of our reply brief, and the net [54*] income and percent return shown in the table marked "Lima Exhibit B" appearing on page 23 of their supplemental brief.* In other words, counsel now claim that instead of approximately $71,500 a year of actual operating costs being ignored there should be a disregarding of such costs in an average amount of over $80,000 a year.

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*NOTE: In line 16 of the table appearing on page 21 of counsel's supplemental brief, they call attention to errors of $732.58 and $105.00, occurring in footings shown on page 35 of our reply brief. The corrections should be made. The table on page 35 was originally set up and totalled before the corrections in the commission calculations were submitted to Mr. Herbert. Revision made in conference changed slightly certain of the commission average expense items. In the table on page 35, the corrections were made in the specific accounts, but through oversight the accounts were not re-totalled. While the discrepancies are small and the erroneous totals are nowhere used as the basis for any calculations, we thank counsel for calling the error to the attention of the court and of ourselves.

The short answer to all this is that the attempted arbitrary reductions in actual costs of operation are entirely illegal and therefore it is immaterial whether the sum which it is claimed should be disregarded annually, is $71,500 or $80,000. We think it important, however, to show the court briefly the untenability of the latest device employed by counsel to create the illusion of annual earnings of around 6% under the commission rates. Discussion of the items will serve, also, to illustrate again how shallow has been counsel's consideration of the applicable legal principles and how ill-advised they have been by the commission's so-called "experts" as to the figures which they are trying to change.

[55*] A.

COUNSEL ARE IN ERROR IN CLAIMING THAT THE OPERATING EXPENSES CONSIDERED BY THE COMMISSION INCLUDED COST OF GAS USED TO SUPPLY DELPHOS AND THE NORTH TOWNS.

Counsel's reason for further reducing the item of "Cost of Gas Produced and Purchased" is, they inform the court on page 9 and again in the note on page 23 of their supplemental brief, due to the fact that the operating expenses used by the commission in determining net return included the cost of gas used to supply Delphos and the north towns. In this assertion counsel are in error. The cost of gas sold in Lima as developed by the commission did *not* include the cost of the gas sent to Delphos and the towns north. The costs taken into account by the commission were developed from Company Exhibit 104. (See Deft. Bf., p. 18). The figures so used from Company Exhibit 104, do not include, but exclude, the cost of gas for sale in Delphos and the north towns, as is plainly shown on page 5 (note 2) and page 6 (note 2) of that exhibit.

On those pages, the item designated "Cost of Gas Sent Out" is adjusted and reduced because of the fact that gas was sold to Delphos and in the north towns in 1930 and 1931. It is this reduced figure that correctly appears on page 1 of Company Exhibit 104 as the "Cost of Gas Produced and Purchased" for the *Lima* district. It is this summary on page 1 that the commission "expert" used as [56*] the basis for his original calculations as to operating expense. (See Deft. Bf., p. 18).

The error of counsel (or of their "expert" advisor from the commission staff) grows out of a failure to read what we pointed out on pages 19 and 20 of our reply brief. We showed there that the correction necessary in the commission's calculations, was limited to a correction of the estimated *revenues* from *Lima* service under the commission rates. We there stated the fact that this correction was required because the estimate of such *revenues* was based on Company Exhibit 105, which was introduced to show that "even if the Lima ordinance rate was applied to *all* gas manufactured at the Lima plant, including that sold in Lima for house heating and that sold to or in municipalities outside of the Lima district, still the total *revenues* would not be sufficient to *pay operating expenses applicable to Lima district service alone.*" Those operating expenses, as Company Exhibit 105 shows, are the operating expenses shown on page 1 of Company Exhibit 104.

APPENDIX B.

Discussion of Certain Misstatements and Inaccuracies in the Alleged Statement of Facts in the Opinion of the State Court.

1. On page 304 of its opinion (R. 17), in the first paragraph of the alleged history of the case, the state court, copying the purported statement of facts from the brief of counsel for the commission, states:

> "In 1923 the two properties were combined, the natural gas company securing permission from the Public Utilities Commission to furnish the city with a mixed fuel gas. *By this method* the physical plant of the gas light company was added into the system of the natural gas company and *the loss by obsolescence was avoided.* These two combined systems together with replacements and additions constituted the gas properties now being operated in the city of Lima by the plaintiff in error."

We think this statement necessarily has the effect of producing the impression in the mind of anyone unfamiliar with the situation, that there are now in use in Lima duplicate gas systems, that these were combined without regard to the need for or use of them, and that the properties were so consolidated in order to avoid the retirement of unnecessary facilities.

Such impression would be an incorrect one. It would be contrary to what the record establishes. The evidence in the record in reference to the combination of the two operating companies in Lima is found on pages 146-56 of the printed record. The evidence was first developed by counsel for the city in cross-examination of witnesses for the company. Counsel for the city made certain inquiry

about the location of the mains of the Lima Gas Light Company and those of the Lima Natural Gas Company in certain of the same streets. On pages 152-3 of the record the following is shown:

"Commissioner Maullar: Are you claiming a duplication in the present set-up, Mr. Landis?

"Mr. Landis: *I don't know yet,* Your Honor; *we will find out.*

"Q. What became of these mains and distribution system of The Lima Gas Light Company's pipes when the two companies were merged; that is, when they combined the service? A. Some of them were abandoned; in some cases some of the lines were taken up and the rest of the property, or the rest of the lines were tied in with the natural gas distribution system.

"Q. How much of these pipes was taken up? A. Well, I could not answer that offhand.

"Q. You can find out? A. Yes.

"Q. You say some of them were abandoned? A. Yes, sir.

"Q. What do you mean 'abandoned'? A. Well, it was under permanent paving; besides, *the lines were not necessary and we simply left them there because it would be cheaper to leave them* under the pavement *than to remove them.*

"Q. And you say *some of the others* were tied into the system of The Lima Natural Gas Company? A. Yes; in order that a more equal distribution of gas might be given to the customers that would bring about the excellent service referred to this morning.

"Q. What do you mean 'Equal distribution'? A. Well, the more pipe lines you have and the larger and the greater area you touch you get a more equal distribution of your gas to your customers.

"Q. In other words, if you have a small pipe in this particular location and a larger pipe adja-

cent to it, the one with the larger pipe would get better distribution than the one that had a smaller pipe; is that what you mean? A. Yes, and in addition to what you say, we found a lot of customers that were on artificial gas lines and there wasn't a natural gas service running into the premises, and by tying the lines in we were permitted to use the gas served at that time through the old artificial system, meaning that if the artificial service into that particular place or those particular places had been abandoned, it would have been necessary to run a line from the present system in, and in many instances that was impossible, owing to the fact that the service line from the main to the curb was under permanent paving; and if you already have an artificial service going into that building from the artificial line, by tying that artificial line to the natural gas line we were able to reach a great number of customers that had been using artificial gas entirely and not natural gas at all."

On redirect examination the facts on this subject were further developed. The testimony here shows, *inter alia,* (R. 155-6):

"Q. I will ask you whether any part of these lines was included in the valuation which Mr. Heyser submitted here except those which are used in the natural gas business? A. Only those that are used and useful.

"Q. And the other two are not at all included in the amounts of pipe, are they? A. They are not.

"Q. Now, for instance, on Market street where you tied the lines, the artificial lines on one side of the street, and used it as a supply line, was that economical to do that rather than to increase the size of your natural gas line? A. We considered it a very wise thing to do and very economical because we eliminated a lot of labor cost and additional material cost by tying the two lines together.

"Q. And aside from getting better service as you have explained in answer to Mr. Landis, the fact is that the town has grown westward a mile or two in the last fifteen years, hasn't it? A. It has.

"Q. And without the use of those lines you probably would have had to increase your main natural gas line? A. And in addition to that we perhaps would have had to construct a gas holder at some advantageous point in the western part of the city.

"Q. Besides the expense and inconvenience to the public of digging up the pavement and putting in a new line, etc.? A. That is true.

• • •

"Q. I think you said, but I will ask you again to be sure, whether or not in this valuation which Mr. Heyser prepared and which has been submitted here, there is included a single foot of pipe that was formerly a part of the artificial or Lima Gas Light system that is not used or useful now in the natural gas business or the mixed gas business as it is now. A. Absolutely none."

2. On page 305 of its opinion, the state court has set forth, as facts in the case, allegations made by counsel for the commission in their brief to the effect that the plant and property used and useful in rendering service in Lima are greatly in excess of requirements, and that the commission did not consider this alleged fact in determining its valuation of the property. (R. 18). For example, the court states that the plant "*admittedly* has a capacity of practically two or three times the requirements of Lima;" and that "the commission did not reduce the valuation of this plant."

These assertions are in direct conflict with the evidence. Claims of over-capacity were strenuously advanced before the valuation was made. The commission had the entire

subject fully before it when it made the valuation. It made the deduction for over-capacity recommended by its own engineers. (R. 301).

We direct the court's attention to a bit of the city's own evidence (R. 427):

> "Q. (By Mr. Light) And the artificial plant is large enough to supply *three times* the needs of Lima, either independent of the other?
>
> [Objections overruled.]
>
> "The Witness (Mr. Allensworth): *No, sir, I do not think it is quite that large. I think it is one-third too large* to meet the requirements of Lima."

And on this same subject the commission's own engineers reported (R. 623):

> "At the present time The West Ohio Gas Co. is operating its manufacturing plant 11 to 12 hours per day. If smaller equipment were installed the operation would of necessity be over a longer operating period, thereby entailing an increased yearly operating labor expense of from $3,000.00 to $4,000.00. It is our opinion that this saving in labor necessary for operation would be greater than the savings on the decreased investment made possible with smaller generating equipment."

Even so, they reduced the plant valuation by 15% because of alleged over-capacity. (R. 301).

During the hearings the chairman of the commission propounded special inquiries upon this subject (R. 291-2, 295), which were answered by witnesses for the city and the company. (R. 555-66, 617-9). There is additional evidence on the subject on the following pages of the printed record. (R. 201-6, 237-8, 248-9, 265, 276-9, 286-7, 288-90, 401, 426-8, 515, 525, 170-1, 620-1).

All these facts were specifically set forth in the briefs before the state court.

3. On page 306 of its opinion the court, again adopting the unsupported assertions of counsel for the commission, states as a fact that the total production cost of the mixed gas is 32½ cents per thousand cubic feet according to the company's figures. The record as to the holder cost of the mixed gas, *i. e.*, the cost of the natural gas and the bare manufacturing cost of the water gas (exclusive of taxes and return on investment) is shown in the record to be as follows (R. 334):

> "Commissioner Bricker: I think this is in the record some place, but what is approximately the cost per thousand cubic feet of producing your water gas?
>
> "The Witness: Holder cost for gas in the gas holder ready for distribution?
>
> "Commissioner Bricker: Yes.
>
> "The Witness: 1931, the holder cost was 37.79 cents.
>
> "Mr. Light: That is the mixed or the blue gas?
>
> "The Witness: That is the mixed gas in the holder ready to go into the distribution system. The year 1930 was 35.56 cents. Year 1929, 35.51 cents. The year 1928, 35.37. And the year 1927, 38.53 cents per thousand."

This fact was specifically called to the state court's attention in our reply brief.

4. On the same page of its opinion the state court, again adopting counsel's assertion, states that the company has 93 cents for distribution and profit. That this assertion is a misstatement of fact was pointed out to the state court and the adoption of the statement by that court is but another clear indication that the court did not examine the record. We shall repeat here what we submitted to the state court on this point:

The misstatement by counsel (as to distribution cost and profit) was probably predicated upon a blind acceptance of an unwarranted assertion in the commission order. The commission states on page 2 of its opinion (R. 89-90), that the cost of the mixed gas is approximately 32 cents per thousand cubic feet and that the cost of storage and leakage during distribution is perhaps 3½ cents per thousand cubic feet. It then asserts there that the average cost to the consumer is $1.29 per thousand cubic feet, and that the difference of 93 cents per thousand cubic feet is the cost of "*distribution* alone." It then further asserts that "this seems an unjustified charge *for the service of distribution.*"

The statement by the commission that 93 cents per thousand cubic feet is the cost of distribution, is erroneous and inexcusable. We have already shown the court that the allegation that 32 cents per thousand cubic feet is the cost in the holder is incorrect as shown by the evidence. Likewise, the evidence does not support the claim that 3½ cents per thousand cubic feet covers the cost of storage of gas and leakage during distribution. The rate is in fact considerably higher than this. Furthermore, as the commission must have known, not only from the general testimony, but from Company Exhibit 104 (R. 529-48) and the annual reports which it insisted on using, the inaccurate 32-cent figure it used did not include taxes on the manufacturing plant or transmission lines or return on the investment therein, which items represent a very large portion of the 93-cent figure referred to. In addition, there is no justification for considering that all of the administrative expense of the company is attributable to the service of distribution. Such expense is as necessary in connection with the procuring and manufacturing of the gas as it is in connection with the distribution thereof.

The statement of the commission is wholly unfounded. It is untrue and serves but one purpose,—that is, to create a false impression to the prejudice of the company.

We also ask the court to keep in mind the fallacy of attempting to compare blindly on a M. C. F. (thousand cubic feet) basis the cost of rendering gas service. This may be readily illustrated.

Consider any community in which gas utility service is being rendered. The costs for reading meters and for preparing and sending out bills are, generally speaking, the same for each customer served within that community. That is, in a given community it costs (except in isolated cases where some unusual condition exists) about the same amount to read each meter, and about the same amount to prepare and send out each bill. These costs are not affected by the volume of the product used. Now consider two customers in that community,—A using one thousand cubic feet of gas per month, and B using five thousand cubic feet in the same period. The expense of reading the two meters and sending out the bills is identical in each case; yet, the cost per M. C. F. for these services is five times as great in the case of A as in the case of B. Clearly it would be a most specious argument to urge that although the expense of such service to B was reasonable, the expense of the service to A was five times too high. The fact that such differential on an M. C. F. basis exists isn't the slightest indication that the charge to A is unreasonable. As a matter of fact if the expense in the case of B is reasonable, it necessarily follows that the expense as applicable to A's service is reasonable. The services are performed at the same cost. The argument of counsel for the commission on this point is exactly the specious one just pointed out. If their contention were adopted it would be necessary to hold in respect to the illustration just given that the ex-

pense in A's case is unjustifiable, because on an M. C. F. basis it is several times greater than in the case of B.

5. On page 303 of its opinion (R. 16), the state court makes the following assertion:

> "The claim is made that residents of the city of Lima pay more for their gas per thousand cubic feet than any other city of Ohio. This is denied. Comparisons are made by way of proof and disproof. These comparisons add volume to the briefs, but are of little, if any, aid to the court."

The claim was a query during cross-examination. We quite agree that the claim is of no aid to the court. However, since the court saw fit to refer to the subject, it should be pointed out that the testimony of the witness shows the claim to be incorrect. (R. 221-4, 419-24). The *"volume"* on the subject in the briefs consists wholly of two sentences, totalling seven lines, in the initial brief of counsel for the commission; of two sentences, totalling sixteen lines, in the supplemental brief filed for the commission; and of a single paragraph in our supplemental reply brief calling attention to the record on this subject. One of the two sentences contained in the initial brief for the commission is repeated in the court's alleged statement of facts, pages 306-7. It is that

> "The tariffs on file at the commission show that natural gas out of this same transmission line is sold by the Ohio Fuel Gas Company at Ada, Ohio, within twenty miles of Lima, at 65c per thousand."

The statement is inaccurate. Obviously the tariffs had not been examined. Those tariffs applicable to Ada provide a rate of $1.50 for the first thousand cubic feet and a minimum charge of $1.50 per month. Additional gas is sold at 63 cents gross per thousand cubic feet. And if the state court or counsel desired to discuss what the commission's files show as to gas rates in the vicinity of Lima

each ought, in fairness, to have stated also that at Van Wert, about twenty-nine miles from Lima, artificial gas is sold at a flat rate of $2.50 per thousand cubic feet, with a monthly minimum of 50 cents.

6. On page 306 of its opinion, the court refers to the fact that there is evidence that the heating content of the gas supplied by the company does not average over 475 British thermal units per cubic foot, instead of 550 British thermal units. The record shows that the company keeps a constant check as to heating content and that this is recorded by an automatic Thomas recording calorimeter, which is inspected and tested every few months. If this court considers the issue of any importance, as far as this case is concerned, we respectfully ask it to examine the entire record as to the quality and character of service and to keep in mind that not one single complaint by a customer as to the quality of service was shown in evidence. The complete record touching upon this general subject is, we believe, found in the following pages of the printed record: 130-1, 143-5, 156, 188-98, 254-5, 267, 279-88, 293, 568-72, and in Company's Exhibits A and H, which were transmitted to this court as original exhibits and are two of the monthly charts, automatically recorded by the Thomas calorimeter.

7. On pages 304-5 of its opinion the court, following counsel's unsupported statements, says that

> "In December, 1924, on the occasion of the transfer of the assets to the West Ohio Gas Company, the commission authorized the issuance of $3,376,000 of *bonds* and *preferred stock* securities." (R. 17-8).

We presume this statement was probably intended to suggest that the cost of capital was due to the issuance of too great a proportion of preferred securities. It is inaccurate. What the record referred to does show, is that

at the time of the organization of the West Ohio Gas Company *securities* of a total face value of $3,376,000.00 were authorized by the commission. Of these securities there were $1,000,000.00 face value of bonds and $750,000.00 par value of preferred stock. The remainder was common stock. (R. 553). The fact is that the bonds and preferred stock, which were all the preferred securities issued by the company prior to 1932, were less in face amount than the low value of $1,901,696.26 found by the commission as the value of the Lima property alone.

8. On page 305 the state court asserts, as counsel did, that this "order" (the order fixing the purchase price of the property acquired by the West Ohio Gas Company) "was based *upon previous appraisals* and not related to purchase price." (R. 18). The purpose of this statement is not clear unless it is to create the impression of overcapitalization. Regardless of its aim, it is both untrue and directly in conflict with the record. (R. 406, 396-7, 401-2). This fact was pointed out to the court in the briefs.

9. On the same page, the court adopts counsel's statement that "Eight per cent. preferred stock, an issue of $750,000, was sold to *another* Insull company at 87½." The stock was in fact 7% preferred stock. The statement that the stock was sold "to *another* Insull company" is incorrect. It seems intended to create the impression of a series of transactions between related companies. Such of the stock as could not then be marketed was bought by the Midland Utilities Company, the owner of the common stock. The entire facts as to the issuance and disposal of the preferred stock securities are set out in the record, and were called to the state court's attention. (R. 513-4).

APPENDIX C.

Applicable Statutory Provisions.

General Code of Ohio, Section 499-14:

The commission shall have power to establish a system of accounts to be kept by the public utilities or railroads (including municipally owned or operated utilities), or to classify said public utilities or railroads and to establish a system of accounts for each class, and to prescribe the manner in which such accounts shall be kept; * * * Where the commission has prescribed the forms of accounts, records or memoranda to be kept by any public utility or railroad for any of its business, it shall thereafter be unlawful for such public utility or railroad to keep any accounts, records or memoranda for such business other than those so prescribed, or those prescribed by or under the authority of any other state or of the United States, excepting such accounts, records or memoranda as shall be explanatory of and supplemental to the accounts, records or memoranda prescribed by the commission. The commission shall at all times have access to all accounts kept by such utilities or railroads and may designate any of its officers or employes to inspect and examine any and all such accounts. It shall be the duty of the auditor or other chief accounting officer of any such utility to keep such accounts and make the reports provided for in section 614-48 of the General Code. Whoever being such auditor, or chief accounting officer, violates or fails to comply with the provisions of this section shall upon conviction thereof be subject to the penalties provided for in section 614-65 of the General Code. It shall be the duty of the attorney general to enforce the provisions of this section upon request of the commission, by mandamus or other appropriate proceedings.

General Code of Ohio, Section 544:

A final order made by the commission shall be reversed, vacated or modified by the Supreme Court, on a petition in error, if upon consideration of the record such court is of the opinion that such order was unlawful and unreasonable.

General Code of Ohio, Section 545:

The proceeding to obtain such reversal, vacation or modification shall be by petition in error, filed in the Supreme Court, by any party to the proceeding before the commission, against the Public Utilities Commission of Ohio, setting forth the errors complained of. Thereupon unless the same is duly waived a summons shall issue and be served, as in other cases, upon the chairman of the commission, or, in the event of his absence, upon any member of the commission, or by leaving a copy at the office of the commission at the city of Columbus. The court may permit any interested party to intervene by cross-petition in error.

General Code of Ohio, Section 546:

Upon service or waiver of the summons in error the commission shall forthwith transmit to the clerk of the Supreme Court a transcript of the journal entries, original papers or transcripts thereof and a certified transcript of all evidence adduced upon the hearing before the commission in the proceeding complained of, which shall be filed in said court.

General Code of Ohio, Section 547:

No proceeding to reverse, vacate or modify a final order of the commission shall be deemed commenced unless the petition therefor is filed within sixty days after the entry

of the final order complained of upon the journal of the commission.

General Code of Ohio, Section 549:

No court other than the Supreme Court shall have power to review, suspend or delay any order made by the commission, or enjoin, restrain or interfere with the commission or any member thereof in the performance of official duties. Nor shall the writ of mandamus be issued against the commission or any member thereof by any court other than the Supreme Court.

General Code of Ohio, Section 614-44:

Any municipal corporation in which any public utility is established may, by ordinance, at any time within one year before the expiration of any contract entered into under the provisions of Secs. 3644, 3982, and 3983 of the General Code between the municipality and such public utility with respect to the rate, price, charge, toll or rental to be made, charged, demanded, collected or exacted, for any commodity, utility or service by such public utility, or at any other time authorized by law proceed to fix the price, rate, charge, toll or rental that such public utility may charge, demand, exact or collect therefor for an ensuing period, as provided in Secs. 3644, 3982 and 3983 of the General Code. Thereupon the commission, upon complaint in writing, of such public utilities or upon complaint of one per centum of the electors of such municipal corporation, which complaints shall be filed within sixty days after the passage of such ordinance, shall give thirty days' notice of the filing and pendency of such complaint to the public utility and the mayor of such municipality of the time and place of the hearing thereof, and which

shall plainly state the matters and things complained of. • • • Upon such filing, the commission shall forthwith give notice of the filing and pendency of such complaint to the mayor of such municipality and fix a time and place for the hearing thereof. The commission shall, at such time and place, proceed to hear such complaint, and may adjourn the hearing thereof from day to day. The filing of a complaint by a public utility, as herein provided, shall be taken and held to be the consent of such public utility to continue to furnish its product or service, and devote its property engaged therein to such public use during the term so fixed by ordinance or by the provisions of this act. Parties thereto shall be entitled to be heard, represented by counsel, and to have process to force the attendance of witnesses.

General Code of Ohio, Section 614-46:

If the commission, after such hearing, shall be of the opinion that the rate, price, charge, toll or rental, so fixed by ordinance is or will be unjust or unreasonable, or insufficient to yield reasonable compensation for the service, the commission shall, with due regard to the value of all the property of the public utility, actually used and useful for the convenience of the public, excluding therefrom the value of any franchise or right to own, operate or enjoy the same in excess of the amount (exclusive of any tax or annual charge) actually paid to any political subdivision of the state or county as a consideration for the grant of such franchise or right; and exclusive of any value added thereto by reason of a monopoly or merger and to the necessity of making reservations from the income for surplus, depreciation and contingencies, and such other matters as may be proper, according to the facts in each case, fix and determine the just and reasonable rate, price,

charge, toll or rental to be charged, demanded, exacted or collected by such public utility, during the period so fixed by ordinance which shall not be less than two years, and order the same substituted for the rate, price, charge, toll or rental so fixed by ordinance or the commission may find and declare that the rate, price, charge, toll or rental, so fixed by ordinance is just and reasonable, and ratify and confirm the same.

No such rate, price, charge, toll or rental so determined by the commission shall become effective or valid until after the commission shall have ascertained and determined the valuation upon which such price, charge, toll or rental is based as provided in this act. And such valuation so determined shall be, at all times, open to public inspection. Thereupon the commission shall make inquiry and investigation with respect to the ability of such public utility to furnish its product during such period, if it be found that it is able so to do, the commission shall order the public utility in question to continue to furnish the same for the period and at the rate, price, charge, toll or rental so fixed and determined, and such public utility shall continue to furnish its product as provided in such order. If the commission, after the hearing provided for in Sections 614-44 and 614-46 of the General Code shall be of the opinion that any provisions of the ordinance appealed from or complained of other than the rate, price, charge, toll or rental fixed thereby are or will be unjust or unreasonable or that the form and structure of the rate, price, charge, toll or rental fixed thereby may be unfair or unreasonable, or may have the effect of causing any rate, price, charge, toll or rental to be fixed by the commission to become unfair or unreasonable, the commission shall in its order strike out such unjust or unreasonable provisions, conditions, form and structure of said ordinance and shall substi-

tute therefor, if it deem it necessary such provisions and conditions as it may consider fair and reasonable, and make such changes in the form and structure of the rate, price, charge, toll or rental fixed in such ordinance as it may consider fair and reasonable.

General Code of Ohio, Section 3982:

The council of a municipality in which electric lighting companies, natural or artificial gas companies, gas light or coke companies, or companies for supplying water for public or private consumption, are established, or into which their wires, mains or pipes are conducted, may regulate from time to time the price which such companies may charge for electric light, or for gas for lighting or fuel purposes, or for water for public or private consumption, furnished by such companies to the citizens, public grounds, and buildings, streets, lanes, alleys, avenues, wharves, and landing places, or for fire protection. Such companies shall in no event charge more for electric light, natural or artificial gas, or water, furnished to such corporation or individuals, than the price specified by ordinance of council. The council may regulate and fix the price which such companies shall charge for the rent of their meters, and such ordinance may provide that such price shall include the use of meters to be furnished by such companies, and in such case meters shall be furnished and kept in repair by such companies and no separate charge shall be made, either directly or indirectly, for the use or repair of them.

General Code of Ohio, Section 3983:

If council fixes the price at which it shall require a company to furnish electricity or either natural or artificial gas to the citizens, or public buildings or for the purpose of lighting the streets, alleys, avenues, wharves, landing

places, public grounds or other places or for other purposes, for a period not exceeding ten years, and the company or person so to furnish such electricity or gas assents thereto, by written acceptance, filed in the office of the auditor or clerk of the corporation, the council shall not require such company to furnish electricity or either natural or artificial gas, as the case may be, at a less price during the period of time agreed on, not exceeding such ten years.

General Code of Ohio, Section 5483:

• • • In the month of October, annually, the auditor of state shall charge, for collection from each electric light, gas, natural gas, waterworks, telephone, messenger or signal, union depot, heating, cooling and water transportation company, a sum in the nature of an excise tax, for the privilege of carrying on its intra-state business, to be computed on the amount so fixed and reported by the commission as the gross receipts of such company on its intra-state business for the year covered by its annual report to the commission, as required in this act, by taking one and thirty-five one-hundredths per cent of all such gross receipts, which tax shall not be less than ten dollars in any case.

General Code of Ohio, Section 2294-4:

• • • For the purpose of providing funds for poor relief and of the carrying out of the other purposes and provisions of this act, a sum in the nature of an excise tax for the privilege of carrying on its intra-state business in the amount of one per centum of the gross receipts of each electric light, gas, natural gas, waterworks, telephone, messenger or signal, union depot, heating, cooling, water transportation, and telegraph company, on its intra-state business from and after the effective date of this act, as covered by the annual reports required by law to be filed

by all such companies as are herein before mentioned in the years 1932, 1933, 1934, 1935, 1936, 1937, is hereby levied and imposed upon each such company in each of said years, such tax to terminate five years after the final date covered by the annual report filed by each of such companies in the year 1932; • • • The sum so levied to be in addition to the taxes provided for in Sections 5468, 5483, 5485 and 5488 of the General Code, and to be collected on the dates and in the manner provided in said sections.